IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

No. 77-1724

HARRY G. BURKS, JR., EDWARD B. BURR, THOMAS F. CHALKER, JOHN R. HAIRE, HARVEY C. HOPKINS, S. P. HUTCHISON, DONALD L. KEMMERER, A. S. MIKE MONRONEY, CHARLES F. PHILLIPS, JEPTHA H. WADE, ANCHOR CORPORATION and FUNDAMENTAL INVESTORS, INC.,

Petitioners,

—v.—

HOWARD M. LASKER and IRVING GOLDBERG,

Respondents.

RESPONDENTS' BRIEF

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases:

PAGE

PAGE

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Petitioners,

—v.—

Howard M. Lasker and Irving Goldberg,

Respondents.

RESPONDENTS' BRIEF

Question Presented

Can minority directors of a registered mutual fund who were nominated by the majority directors of the fund to be "independent" directors pursuant to the requirements of the Investment Company Act terminate a validly commenced nonfrivolous stockholder's derivative action against the fund's majority directors and its investment adviser based upon violations of the Act and other breaches of fiduciary duties?

Statutory Provisions Involved

The following statutory provisions are involved:

Section 1 of the Investment Company Act, codified in 15 U.S.C. §80a-1 (1976) (at pp. 1006-07);

Section 13(a)(3) of the Investment Company Act, codified in 15 U.S.C. §80a-13(a)(3) (1976) (at p. 1027);

Section 17 of the Investment Company Act, codified in 15 U.S.C. §80a-17 (1976) (at p. 1033);

Section 36 of the Investment Company Act as it existed prior to December 14, 1970, Act of Aug. 22, 1940, ch. 686, Title I, §36, 54 Stat. 841;

Section 206 of the Investment Advisers Act, codified in 15 U.S.C. §80b-6 (1976) (at p. 1070);

Rule 23.1 of the Federal Rules of Civil Procedure.

Statement of the Case

The decision of the District Court permitted a minority of a board of directors to dismiss a validly commenced derivative action alleging serious, factually detailed, and largely substantiated charges of wrongdoing against their co-fiduciaries on the basis of business judgment. That determination was the first judicial approval of such a procedure. The District Court's action was a drastic departure from settled doctrine governing the prosecution of derivative suits. The Second Circuit unanimously reversed.

If the procedure approved by the District Court is reinstated here, the net effect will be to curtail gravely, if not to destroy, shareholder enforcement of derivative claims seeking redress for insider abuses. A new and potent weapon will have been manufactured to frustrate private

enforcement of the securities laws. Implied rights will exist, but they will be unenforceable. Corporate responsibility will not be promoted. The boardroom will simply be left to its own unfettered schemes.

This is a stockholders' derivative action brought on behalf of Fundamental Investors, Inc. (the "Fund"), a federally regulated mutual fund, seeking recovery of investment losses sustained in connection with the Fund's purchase of $20,000,000 worth of nine-month Penn Central Transportation Company commercial paper prior to that company's financial collapse. Defendants in the case, petitioners herein, are the Fund's investment adviser, Anchor Corporation ("Anchor"), and the Fund's directors at the time of the acts complained of. Plaintiffs' claims arise under the Investment Company Act of 1940, the Investment Advisers Act and the common law.

The Investment in Penn Central Paper

Between November 28, 1969 and December 8, 1969, Anchor caused the Fund to purchase Penn Central notes as a purported liquidity measure from Goldman, Sachs & Co., an investment banking house (A. 86). Goldman, Sachs, in selling the notes to the Fund, was a principal acting for its own account (A. 84-85). These purchases were the largest investment made by the Fund during that period.

In consummating the transactions for the Fund, Anchor did not conduct any independent research or analysis whatsoever (A. 86, 95). Anchor also violated two out of the three investment guidelines which it had established to safeguard the Fund in connection with the purchase of commercial notes from dealers: (i) it failed to include an automatic buy-back provision as a condition of purchase and (ii) it caused the Fund to hold more than ten percent of an outstanding issue (A. 84, 109, 113).

Anchor failed to do any initial investigation before the purchases and made them in spite of adverse information which was publicly available on October 20, 1969 and in November. *University Hill Foundation* v. *Goldman, Sachs & Co.*, 422 F. Supp. 879, 889 n.10, 889-90 (S.D.N.Y. 1976). After the purchases Anchor did nothing to inform itself as to Penn Central's increasingly precarious financial condition, in gross neglect of its legal and moral responsibilities to the Fund's shareholders (A. 101). An adverse public report was rendered on February 4, 1970. *Franklin Sav. Bank* v. *Levy*, 551 F.2d 521 (2d Cir. 1977). Still, Anchor did not act. Even Penn Central's staggering first quarter 1970 losses of $62.7 million reported in the *Wall Street Journal* on April 23, 1970 failed to move Anchor to action (A. 103).

Apparently oblivious to the mounting warning signals of impending disaster, which were widely reported in the financial press, Anchor made no effort to sell the commercial paper until an article appeared in the May 18, 1970 issue of *Barron's*, which expressed doubt about the safety of commercial paper generally. This article, which did not refer to Penn Central specifically, caused Anchor to seek to reduce the Fund's Penn Central holdings by one-half (A. 87). By this time, however, no one was buying the paper and the Fund continued to hold it when Penn Central filed its petition for reorganization on June 21, 1970 (A. 87, 113).

Anchor, which received advisory fees from the Fund of approximately $4,000,000 a year, had remained in a state of complete ignorance from start to finish.

The disingenuous rationalization offered by Anchor for its failure to do any investigation or review in connection with the purchase and retention of Penn Central paper was that if Goldman, Sachs sold the paper, it must have

been creditworthy (A. 101-02). As a highly paid fiduciary whose responsibilities were to render sophisticated investment advisory services for the benefit of the Fund's shareholders, Anchor recklessly failed to perform any services whatsoever.

The Fund's directors, whose responsibilities were to oversee and supervise the activities of the adviser, similarly failed the shareholders. They were unaware of the procedures being used by Anchor or even that Anchor had begun buying commercial paper from dealers (A. 108).

The Disingenuous Scheme to Terminate This Action

On October 28, 1970, the Fund's Board of Directors met to discuss the Penn Central losses and decided to begin an action against Goldman, Sachs. The directors also decided not to pursue an action against Anchor or others at that time but to defer any decision with respect to such an action until after the Fund's suit against Goldman, Sachs (A. 157; Doc. 10,* Phillips' Affd. ¶7, June 19, 1973). That suit was instituted in November 1970 and settled in July 1974 for $5¼ million—only twenty-five percent of the loss—plus an interest in the potential proceeds of the bankruptcy (A. 87).**

* This and similar references are to the documents in the record numbered in accordance with the Index to the Record filed by plaintiffs in the Court of Appeals.

** Investors Diversified Services makes an awkward attempt to denigrate the present value of plaintiffs' claims because a plan of reorganization was approved for Penn Central. The certificates of beneficial interest to which IDS refers have no established trading value. Their ultimate worth to the Fund, if any, is highly speculative and is contingent on the outcome of certain litigation against the United States concerning the valuation of Penn Central property. *See* Wall St. J., Oct. 25, 1978 at 34, col. 3; *id.*, Mar. 10, 1978 at 37, col. 1. IDS also neglects to mention that interest on plaintiffs' claims, which defendants concede is running, is presently in excess of $7,000,000.

The present suit was begun in February 1973 and was stayed pending determination of the suit against Goldman, Sachs. In granting the stay, Judge Gurfein required all defendants to execute waivers of the statute of limitations. When the Goldman, Sachs case was settled, the stay was lifted and the question of what to do about Anchor and the instant litigation was again at hand (Haire Tr. 175-76). Defendant John R. Haire, President of the Fund and Chairman of Anchor, and Mr. Roger T. Wickers, an officer of the Fund and Anchor (but not a director of the Fund), both lawyers, devised a plan to use those five of the Fund's eleven directors who were not defendants in the case or affiliated with Anchor to bring about a dismissal of this action (Haire Tr. 239, 244-45).* The plan was successfully orchestrated and executed in the following manner:

(1) Haire instructed Wickers to explore the retention of special counsel (Haire Tr. 247, 250). Wickers ascertained that retired Judge Stanley H. Fuld would be available (Haire Tr. 250-51, 254).

(2) Thereafter, at the next Fund board meeting, Wickers presented to the directors a proposal that a disinterested "minority quorum" consider the Fund's position with respect to the litigation (Kendall Tr. 104-06; Stephens Tr. 48-49). Wickers suggested several persons who might be retained to act as special counsel and specifically stated that Judge Fuld was available (Kendall Tr. 125). The five minority directors agreed to look into the matter and told Wickers to contact Judge Fuld and have him review the case (A. 157; Haire Tr. 262).

(3) Judge Fuld was subsequently retained. He conducted an investigation and rendered a report in which he ex-

* This and similar references are to transcripts of depositions taken pursuant to the District Court's first opinion (A. 20).

pressed his opinion that the present case against Anchor and the Fund's directors was without merit (A. 82). Judge Fuld based his conclusion on what he believed to be an absence of any direct legal authority on the issue of whether an investment adviser is required to conduct independent research in connection with investment recommendations (A. 96, 97, 100, 102, 108). As is shown in Point V(B), this opinion was erroneous.

(4) Based largely on (i) Judge Fuld's mistaken conclusion that this case lacked merit and (ii) an irrational fear that if the action went forward an adversary relationship would ensue between Anchor and the Fund requiring the termination of Anchor's advisory contract,* the five minority directors determined to seek dismissal of the instant suit against Anchor and their brethren directors (A. 77-8).

(5) All defendants then moved to dismiss the action on the basis of the business judgment of the minority directors.

The District Court specifically declined to consider the merits of this case and held, as a matter of law, that the minority directors had the power to act to terminate this action provided they did so in good faith (A. 19). Since plaintiffs had raised an issue as to the actual independence of the minority directors, the Court ordered discovery restricted solely to the issue of the relationship between the minority directors and the Directors' Qualifications Committee which had selected them (A. 20).

The Minority's Lack of Independence

Although discovery was severely limited by the District Court's order, it nonetheless disclosed numerous factors

* As discussed *infra*, pp. 11-12, the disinterested quorum took a completely opposite viewpoint in subsequently approving a transfer of Anchor's services in a transaction in which Anchor received $4,000,000.

precluding any possible determination that the minority directors, under the circumstances of this case, could have exercised independent judgment.*

(1) The so-called quorum constituted only a minority of the Fund's board, the remaining six directors being either alleged wrongdoers or affiliated with Anchor, or both. Each member of the quorum had been screened, selected and nominated for office by Anchor and the individual defendants who, as majority directors, at all times had the absolute power to effect their removal.

(2) The quorum directors were simultaneously selected for and held identical positions with the other five funds within the Anchor Group of Mutual Funds for which they received remuneration of from $11,000 to $13,000 per year (Haire Tr. 21-22; Doc. 76, Tersigni Affid., Sept. 20, 1976, Exh. G).

(3) Members of the quorum were friends with one or more of the defendants, with whom they had long histories of business and social contacts prior to joining the boards of Anchor's funds.

(4) The Fund itself was little more than a corporate shell totally dependent on Anchor for its operational existence. Anchor's domination and control of the Fund was complete at all levels. Anchor supplied and paid the salaries of all Fund officers, executive and administrative personnel. Anchor supplied, at its own expense, the Fund's office space (at Anchor's headquarters) and all office equipment, supplies and services (Haire Tr. 38-39; Doc. 84, Pls. Exh. 1, Advisory Contract, p. 2).

(5) Anchor held all key executive positions. Mr. Haire, Anchor's Chairman, was the Fund's President and Chief

* See Point V(A), *infra*.

Executive Officer, as well as a director. Mr. Burr, Vice-Chairman of Anchor, was Chairman of the Fund's board. Mr. Martin, President and a director of Anchor, was Executive Vice President of the Fund and a director. Mr. Hutchison, President and a director of Washington National Corporation, Anchor's parent company, was also a director of the Fund (Doc. 60, Fund Prospectus, May 1, 1974, p. 19).

(6) Defendants, as a majority of the board, controlled the Fund's proxy machinery. The Fund had in excess of 104,000,000 shares owned by approximately 141,000 shareholders (Doc. 76, Tersigni Affid., Sept. 20, 1976, Exh. H). No shareholder owned more than one percent of the stock (Doc. 76, Tersigni Affid., Sept. 20, 1976, p. 2). The cost of a proxy contest by the members of the minority would have been prohibitive. Waging such a contest would not have been a feasible alternative for any attempted assertion of control by the minority directors.

Despite overwhelming evidence that the minority directors were not in fact independent and had reached their decision on inaccurate assumptions, the District Court, finding no indication that the quorum had acted other than independently, held that it could not substitute its judgment for that of directors (A. 28). In somewhat startling language, the District Court concluded, "[h]ere, there has been no showing by the plaintiff of facts which, if proven, would prohibit the defendants from *hiding behind the business judgment cloak*" (A. 38) (emphasis added). Without joinder of issue or any discovery on the merits or an opportunity to examine special counsel,* the District Court granted summary judgment for defendants.

* It is significant to note that neither the minority directors nor special counsel saw fit to solicit the views of plaintiffs' counsel.

The Court of Appeals' Decision

The Court of Appeals unanimously reversed on the facts and the law and remanded the case for proceedings on the merits. The Court of Appeals carefully examined the relationship of the minority directors to the defendants and concluded, "it cannot be expected that the public or the Fund's stockholders would believe that these five statutorily disinterested directors could act with that impartiality and objectivity which the public interest requires" (A. 47). The Court of Appeals further found that there was a "symbiotic relationship" between the Fund and Anchor and that the minority directors "owe[d] their position as directors to the defendants in the suit" (A. 48 n.14). Based upon a further finding that the plaintiffs' claims were substantial and meritorious, the Court concluded that the policies of the Investment Company Act precluded dismissal at the behest of the minority directors. The Court stated

> It is undisputed that Anchor never made any independent investigation of Penn Central's financial situation before the Fund's purchase of the notes. Moreover, although reports of Penn Central's operations in early 1970 showed mounting losses, it was not until May that the Fund officers made any attempt to resell any part of the notes to Goldman, Sachs, or otherwise to realize on the investment. . . .
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> . . .
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> From what this record discloses regarding the Fund's investment in Penn Central notes on Anchor's advice, we cannot say that, following a trial on the merits, the defendants would be found free from liability for the Fund's losses. We see nothing in the findings of Congress, the legislation regulating investment companies and their advisers, or in the decisions of the courts which suggests that under such circumstances disinterested directors, such as the five who acted here, have the power to terminate litigation brought by mutual fund stockholders against the fund's investment adviser and its majority directors for breach of their fiduciary duties. On the contrary, the findings of Congress, the statutory scheme, and the relevant case law persuade us that the statutorily disinterested directors of a registered investment company were never meant to have the final word in determining whether it is in the best interest of a mutual fund to press claims against their co-directors, and the adviser with which those directors are affiliated, for breach of fiduciary duties.

A. 40-41, 43.

Defendants' petition for a rehearing in banc was denied by the Court of Appeals, following which this Court granted *certiorari.*

The Subsequent Transfer of Anchor's Advisory Services

The Court of Appeals' decision was rendered on January 11, 1978. On February 10, 1978 Anchor announced that an agreement in principle had been reached to transfer its advisory and underwriting services for all funds within the Anchor Group to Capital Research and Management Company (Fund Proxy Statement, June 12, 1978). Anchor's parent, Washington National Corporation, was paid $4,000,000 for the transfer (*New York Post,* Aug. 2, 1978, p. 83).* Of critical importance is the fact that Anchor no longer is the Fund's adviser. Thus, the pur-

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* Litigation was commenced which challenged the transaction. In rejecting the challenge, the court referred to the fact that in approving the transfer six directors had "discussed the poor investment results which had been achieved by the Anchor Group of Funds. . . ." Reserve Management Corp. v. Anchor Daily Income Fund, Inc., [Current] Fed. Sec. L. Rep. (CCH) ¶96,566 at p. 94,367 (S.D.N.Y. 1978). Five of those six directors are the same individuals who constituted the minority group which deter-

ported business justification given by the directors for seeking to bar further prosecution of this litigation no longer has any colorable basis in fact or reason.

There Has Been a Substantial Change in Circumstances Which Suggests That the Writ of Certiorari Should Be Dismissed

The basic thread which runs through the argument submitted in support of the Petition For A Writ of Certiorari and in support of defendants' arguments before this Court is that continued prosecution of this action would be highly detrimental to the Fund because it would place it in an adversary relationship with its adviser, Anchor.

At the time the Petition herein was filed, June 2, 1978, we were unaware of the fact that on February 10, 1978 Anchor had announced an agreement in principle to transfer its advisory and underwriting services to an independent company for $4,000,000.*

As noted above, that transfer has now been completed and Anchor no longer has any relationship with the Fund. It is, therefore, impossible for any party to suggest that disruption of the working relationship between Fundamental and Anchor furnishes a reasonable basis for reversal.

In this regard, it is significant to note that defendants never advised the Court of this impending transaction:

mined that this action should be dismissed (*id.* at p. 94,365). Also, the court noted that a proposal had been made by another adviser to become the Fund's adviser but to continue existing Anchor investment management personnel. This proposal "apparently was unanimously rejected out-of-hand by the independent directors" (*id.* at p. 94,367).

* This included all funds within the Anchor Group.

it is not mentioned in the Petition or in the briefs submitted by any of the parties.* We first become aware of the transfer when litigation concerning it was reported in the newspapers in August, 1978.

In these circumstances, we respectfully suggest that it would be appropriate for this Court to dismiss the writ of certiorari since one of the fundamental issues raised has been rendered moot. *See Bankers Trust Co.* v. *Mallis,* 435 U.S. 381, *reh. denied,* 436 U.S. 915 (1978); Stern & Grossman, Supreme Court Practice §5.15 (1978 ed.).

Summary of Argument

Plaintiffs' basic position is that the minority directors of the Fund had no power or authority to request the dismissal of this action. In short, the application should have been denied out-of-hand.

Our assertion of lack of power to even bring the issue before the court arises from several sources:

A. As found by the Second Circuit, the Investment Company Act of 1940 does not contemplate that disinterested directors should possess such power and, indeed, negates the existence thereof.

B. Under Rule 23.1, a threshold question in any derivative action is that of demand. A demand is excused whenever a numerical majority of the board is disqualified. We submit that the device employed by the defendants here would render the demand rule meaningless.

* The *amicus* brief of IDS cites the related *Reserve* litigation concerning the proposed transfer as support for certain of its arguments (Br. pp. 38 n.31, 49 n.36) but avoids any disclosure of the underlying facts.

C. We have found no case where a minority quorum has been able to dismiss a nonfrivolous derivative action. All of the applicable authority mandates a contrary resolution of the issue. Indeed, with the exception of two cases decided after the District Court's decision here, we know of no decision where a court has even entertained a dismissal application at the behest of a minority quorum.

D. Concepts developed to assure fair access to the federal courts to redress violations of federal law and accepted state standards with respect fiduciary obligations bar the minority quorum from seeking dismissal of this action.

Moreover, we submit that even if the application to dismiss was properly before the District Court, that application should have triggered a full hearing pursuant to Rule 23.1, including an exploration of the merits of the basic action, the appropriateness of the dismissal recommendation and the overall fairness to the stockholders. On the record before this Court there is no doubt that any such application to dismiss should have been denied.

The procedure which defendants urge upon this Court is fraught with difficulties. If sanctioned, it would grant to minority directors a hitherto nonexistent power to terminate validly commenced nonfrivolous derivative actions. The Investment Company Act clearly does not contemplate that such awesome power be granted to "independent" directors in the guise of enhancing their roles as "watchdogs." Indeed, the Act contemplates that the additional powers granted to independent directors be used to enhance the rights of and protections afforded to shareholders —not diminish them.

Moreover, if generally applied to all corporations, the procedure here would be subject to grave abuse and would unduly complicate and extend shareholder litigation. For example, if a corporation had a ten-person board and only one or two directors were disinterested, could they be constituted a committee to review and seek dismissal of an action commenced against their co-directors?

Moreover, plaintiffs would find it difficult, if not impossible, to ferret out the many subtle influences placed upon the minority which might impel it to seek dismissal.

Considerations of fairness, certainty and avoidance of extensive litigation all point to the impropriety of the position urged by the defendants in this litigation.

POINT I

The Policy of the Investment Company Act and the Limited Authority of Statutorily Disinterested Directors Thereunder Demonstrate That Such Directors Lack the Power to Seek the Termination of This Litigation.

Plaintiffs' right to bring this action derives from rights arising under the Investment Company Act and the Investment Advisers Act and compliance with the standing requirements of Rule 23.1 of the Federal Rules of Civil Procedure. *See Abrahamson* v. *Fleschner,* 568 F.2d 862, 873 (2d Cir. 1977), *cert. denied,* 436 U.S. 905 & 913 (1978); *Galfand* v. *Chestnutt,* 545 F.2d 807 (2d Cir. 1976); *Moses* v. *Burgin,* 445 F.2d 369, 373 (1st Cir.), *cert. denied,* 404 U.S. 994 (1971); *Kauffman* v. *Dreyfus Fund, Inc.,* 434 F.2d 727, 734 (3d Cir. 1970), *cert. denied,* 401 U.S. 974 (1971); *Levitt* v. *Johnson,* 334 F.2d 815, 819 (1st Cir. 1964), *cert. denied,* 379 U.S. 961 (1965); *Brown* v. *Bullock,* 194 F. Supp. 207, 220-28 (S.D.N.Y.), *aff'd,* 294 F.2d 415 (2d Cir. 1961).

Defendants have never challenged plaintiffs' right to bring this action.* The issue raised here is whether the

* Defendants concede that "the existence of a private right of action [is] a subject *not* at issue in this case . . ." (Pet. Br. 28)

Fund's minority directors have the power to request the courts to terminate the action. The Court of Appeals held they did not. An analysis of the Investment Company Act and its purposes fully supports the Court's ruling.

A. *Sections 1 and 17 of the Investment Company Act Embody a Strong Congressional Policy of Protecting Shareholders Against Insider Abuse. This Policy Precludes Dismissal of This Action.*

Both the Investment Company Act and Investment Advisers Act were enacted in 1940 as a comprehensive federal regulatory scheme for the protection of investors. The registration and disclosure provisions of the 1933 and 1934 federal securities laws were deemed inadequate to cope with the managerial abuses found to be the order of the day in the mutual fund industry. *See Tannenbaum* v. *Zeller,* 552 F.2d 402, 406 (2d Cir.), *cert. denied,* 434 U.S. 934 (1977); *Brown* v. *Bullock,* 194 F. Supp. 207, 217, 223 (S.D. N.Y.), *aff'd,* 294 F.2d 415 (2d Cir. 1961).

In enacting the 1940 legislation, Congress sought to place the entire operation and management of the mutual fund industry under specific and comprehensive regulation. In *Brown* v. *Bullock, supra,* 194 F. Supp. at 232-33, the court observed

> In certain major respects, the 1940 Act operates as a corporation law for investment companies. . . .
>
> In light of the distinctive character of investment companies and their easy susceptibility to management

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(emphasis added). Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) and Cort v. Ash, 422 U.S. 66 (1975), upon which much of their argument is based, involved the question of whether a federal implied right of action existed. Those cases are inapposite. Here, the question is whether the defendants can use a nonexistent state procedural device to evade substantive statutorily-based federal liability.

> abuses . . ., one of the primary objectives of the 1940 Act was the protection of investment companies as well as investors against the derelictions of investment companies' directors, investment advisers, other fiduciaries, and principal underwriters.

In Section 1 of the Investment Company Act, 15 U.S.C. §80a-1, Congress set forth its "Findings and declaration of policy," which make it clear that state regulation of investment companies is inadequate for shareholder protection and that the Act is to be interpreted so as to ensure that such companies are operated and managed for the benefit of the shareholders, not the directors or the adviser. Section 1(a)(5) thus provides

> [I]t is found that investment companies are affected with a national public interest in that, among other things—
>
> . . .
>
> (5) the activities of such companies, extending over many States, their use of the instrumentalities of interstate commerce and the wide geographic distribution of their security holders, make difficult, if not impossible, effective State regulation of such companies in the interest of investors.

See Harriman v. *E. I. DuPont de Nemours & Co.,* 411 F. Supp. 133, 159 (D.Del. 1975).

Section 1(b) provides in no uncertain terms that "the national public interest and the interest of investors are adversely affected— . . . (2) when investment companies are organized, operated, [or] managed . . ., in the interest of directors, officers [or] investment advisers . . ., rather than in the interest of all classes of such companies' security holders."

Section 1 goes on to provide

> It is declared that the policy and purposes of this subchapter, in accordance with which the provisions of this subchapter shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.

In implementing these provisions, Congress prohibited board ratification of various insider transactions which might otherwise be permissible under state corporate law (Section 17, 15 U.S.C. § 80a-17) and also provided in Section 17(h) for an absolute ban on any clause in any corporate instrument, including the by-laws, which protects or purports to protect an officer or director of an investment company from liability of the kind alleged in the present action.* The procedural ploy attempted by defendants in this case flies squarely in the face of the congressional policy set forth in Sections 1 and 17 of the Act, which defendants nowhere mention.

In *Brown* v. *Bullock*, 194 F. Supp. 207, 237 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961) the court said, "[a]n attempt to immunize a possible violator of the statute

* Section 17(h) of the Investment Company Act provides in part

> After one year from the effective date of this subchapter, neither the charter, certificate of incorporation, articles of association, indenture of trust, nor the by-laws of any registered investment company, nor any other instrument pursuant to which such a company is organized or administered, shall contain any provision which protects or purports to protect any director or officer of such company against any liability to the company or to its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his office.

against liability for his violation was deemed by Congress to be so offensive as to be stricken down as void *ab initio*."

In the instant case defendants, relying on the quorum provisions of the Fund's by-laws as authority for the minority directors' business judgment, have attempted a backdoor immunization in clear contravention of the policy embodied in Section 17(h).

In *Chabot* v. *Empire Trust Co.*, 301 F.2d 458, 461 (2d Cir. 1962) the Second Circuit had before it a clause in a trust agreement requiring shareholders to post security for litigation costs and expenses. In holding the provision violative of Section 17(h) because it protected the directors, the court said, "[i]t is our view that any provision that renders litigation substantially less likely 'protects or purports to protect' directors and officers from liability under the Act."

Here, the defendants do not seek to render litigation less likely; they seek to render it nonexistent.

The court in *Chabot* rejected defendants' argument that the security-for-cost provision was necessary to protect the fund, and ultimately the shareholders, from the expense of defending frivolous actions, noting

> [S]tockholder actions provide that "adequate independent scrutiny" of investment companies to which the Act refers,* and thereby tend to deter violations of the Act and of the common law duties of such companies. By the enactment of §17(h) Congress has expressed its judgment that the latter is the weightier concern—that unscrupulous management presents a greater danger to the financial interests of the shareholders than

* The reference is to Section 1(b)(5).

> do unfounded shareholder actions. It is not for this court to reweigh that judgment.

Id. at 462.

In *Levitt* v. *Johnson*, 334 F.2d 815, 820 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965), the First Circuit refused to allow a state law requirement for a demand on shareholders to frustrate the enforcement of federal rights arising out of the Investment Company Act. Citing the declaration of national policy set forth in Section 1(b) of the Act, the court said, "[w]e believe a rule under which a demand upon the majority stockholders is a condition that cannot be excused in a case such as this is the type of hurdle the Investment Company Act . . . forbids."

The strong policy of the Investment Company Act leads to the conclusion that shareholder review of improper board action should not be abated by the maneuvering attempted in this case.

B. *The Powers Conferred on Disinterested Directors of Mutual Funds Do Not Include the Extraordinary Power to Terminate Validly Commenced Derivative Litigation.*

The Court of Appeals concluded that the minority directors of the Fund lacked the power to terminate this action. This determination was based upon an analysis of the Act.* To understand the basis of this conclusion, it is necessary to explore the nature and purpose of the statutory role conferred on disinterested directors by the Act and the unique structure of the mutual fund industry.

It has been universally recognized that mutual funds are little more than corporate shells, organized, staffed,

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* The Court found it unnecessary to reach the question of whether minority directors of an ordinary business corporation possessed such power (A. 48 n.14). As will be shown, they do not (*infra*, Point II).

equipped, managed and controlled by an external investment adviser, whose primary objective is the maximization of its own profits.

> Because of the unique structure of this industry the relationship between mutual funds and their investment adviser is not the same as that usually existing . . . in conventional corporate relationships. Since a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arms-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy.

S. Rep. No. 91-184, 91st Cong., 2d Sess., *reprinted in* [1970] U.S. Code Cong. & Ad. News 4897, 4901. "[O]pen-end investment companies are typically legal shells without genuine autonomy, controlled by external management interests." Wharton School of Finance & Commerce, *A Study of Mutual Funds*, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 67 (1962) (footnote omitted). "Mutual funds are formed by persons who hope to profit from providing management services to them. Realization of these expectations can best be assured if the funds remain under the effective control of their advisers." Securities and Exchange Commission, *Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 127 (1966).

> A mutual fund is a "mere shell," a pool of assets consisting mostly of a portfolio of securities that belongs to the individual investors holding shares in the fund. The management of this asset pool is largely in the hands of an investment adviser, an independent entity

> which generally organizes the fund and provides it with investment advice, management services, and office space and staff. . . .
>
> This management structure contrasts sharply with that of a typical corporation. In the usual corporate situation, the interests of management and shareholders are identical on most matters. Since the officers who run the corporation are paid directly by the corporation and usually have a substantial equity investment in it, they devote themselves to profit maximization and thus act in the best interests of both the corporation and themselves. Control of a mutual fund, however, lies largely in the hands of the investment adviser, an external business entity whose primary interest is undeniably the maximization of its own profits.

Tannenbaum v. *Zeller,* 552 F.2d 402, 405 (2d Cir.), *cert. denied,* 434 U.S. 934 (1977).

Because management of a fund is in the hands of an external adviser, conflicts of interest between the adviser and mutual fund shareholders are common. They are the order of the day. "The relationship between investment advisers and mutual funds is fraught with potential conflicts of interest. . . . Compensation for these services is determined under an advisory contract, the terms of which are all too often dictated to unwary or negligent fund directors and fund shareholders by the investment adviser." *Galfand* v. *Chestnutt*, 545 F.2d 807, 808 (2d Cir. 1976). "[S]elf-dealing is not the exception but, so far as management is concerned, the order of the day." *Moses* v. *Burgin*, 445 F.2d 369, 376 (1st Cir.), *cert. denied,* 404 U.S. 994 (1971).

Because of the serious conflicts of interest often arising between advisers and fund shareholders, Congress provided in the Investment Company Act that at least forty per-

cent of a mutual fund's board of directors must be comprised of outside, or so-called disinterested, directors (Section 10(a), 15 U.S.C. §80a-10(a)). Where the adviser also is the principal underwriter, as in the present case, a majority of the fund's board must be comprised of disinterested directors (Section 10(b)(2), 15 U.S.C. §80a-10 (b)(2)).*

The primary function of the disinterested directors is to represent shareholder interests and act as "watchdogs" on their behalf in guarding against managerial abuses. *Tannenbaum* v. *Zeller*, 552 F.2d 402, 406 (2d Cir.), *cert. denied*, 434 U.S. 934 (1977).

Thus, Section 15(c), 15 U.S.C. § 80a-15(c), of the Act imposes on disinterested directors a duty to review and approve the contracts of the investment adviser and principal underwriter. Approval of these contracts, in turn, is subject to a shareholder's right of judicial review under Section 36(b), 15 U.S.C. § 80a-35(b), notwithstanding the business judgment of the disinterested directors.

Section 16(b), 15 U.S.C. § 80a-16(b), of the Act requires that a majority of the disinterested directors nominate other disinterested directors to fill vacancies occurring upon an assignment of the advisory contract. Such nominees must then be elected by the shareholders.

Section 32(a), 15 U.S.C. § 80a-31(a), requires that a majority of the disinterested directors select a public accountant. Again, the selection must then be submitted to shareholders for their approval.

In these situations, where special responsibility is vested in the independent directors, they nonetheless lack ultimate decision making power, which is vested in the shareholders.

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* In the present case, since two of the disinterested directors are defendants in the action, the remaining disinterested directors comprised only a minority of the board.

Probably the most important of the above duties assigned to disinterested directors under the Investment Company Act is the approval of the investment adviser's and principal underwriter's contracts under Section 15(c). Congress' rationale for providing a shareholder's right of action under Section 36(b) for judicial review of payments made pursuant to these contracts, even though approved by the independent directors, is of compelling applicability here. The Senate Report recommending passage of the 1970 amendments to the Investment Company Act found that disinterested direcors of mutual funds had no real independence from the adviser, as a practical matter could not sever the relationship between the fund and the adviser, and hence lacked any bargaining power in negotiating the adviser's fees. S. Rep. No. 91-184, 91st Cong., 2d Sess., *reprinted in* [1970] U.S. Code Cong. & Ad. News 4897, 4901. *See also* Securities and Exchange Commission, *Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 131 (1966). Congress concluded that the disinterested directors were not sufficiently independent to protect shareholder interests in this regard. As stated in *Boyko* v. *Reserve Fund, Inc.*, 68 F.R.D. 692, 696 (S.D.N.Y. 1975)

> It thus appears that in enacting Section 36(b) Congress assumed that the directors of the investment company would be antagonistic toward, and unlikely to prosecute, an action against the Fund's advisors for breach of fiduciary duty with respect to the receipt of compensation. In the instant case, the Fund admits its opposition to the lawsuit and argues that a decision of its board not to prosecute the action would be conclusive, thus precluding a shareholder from asserting the claims derivatively. While this rule might be appropriate in other kinds of derivative actions, its application in this context would clearly thwart the purpose of Congress in enacting Section 36(b) since a majority of the board of an investment company is rarely composed of "interested persons" and tangible indications of bias on the part of the unaffiliated majority are rarely present. As stated in the legislative history, control of a mutual fund by its advisor is the result of intangible factors arising out of the unique structure of the industry.

If disinterested directors of a mutual fund, even where they constitute a majority of the board, are statutorily presumed to lack sufficient independence to act dispositively for the shareholders in a suit against the adviser for excessive fees, how can a minority of disinterested directors be deemed competent to terminate a validly commenced nonfrivolous action against the adviser for gross misconduct and gross abuse of trust involving substantially more millions of dollars? The declaration of national policy in Section 1(b) of the Act prohibits any such result.*

As previously indicated, Section 17 of the Act precludes disinterested directors from authorizing or ratifying vari-

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* Defendants erroneously argue that the Court of Appeals imputed the right of a shareholder to sue under Section 36(b) into Section 36(a), 15 U.S.C. 80a-35(a). Plaintiffs' right to bring this suit is based on neither section. The issue addressed by the Court of Appeals was whether the minority directors had the extraordinary power to terminate a shareholder action properly brought. The Court of Appeals said in this respect

> It would surely be anomalous to hold that the statutorily disinterested directors could determine not to pursue litigation against their co-directors for liability which may amount to many millions of dollars, and foreclose the stockholders from *continuing* such litigation, while at the same time stockholders by statute are empowered to recover excess fees paid the adviser and underwriter.

A. 46 (emphasis added).

ous insider transactions, regardless of disclosure, fairness or reasonableness.* Under Section 17(b) such transactions must be submitted in advance to the SEC, which may grant an exemption only if it finds the transaction to be fair, reasonable, without overreaching and consistent with the policies of the Investment Company Act itself.

Thus, if disinterested directors are precluded by the statute from even acting upon transactions in which insiders are personally interested, again, how can they be deemed judicially competent, consistent with the purposes of the Act, to absolve summarily the same persons from millions of dollars in personal liability as they have attempted to do here? Clearly they cannot.

Congress intended that disinterested directors serve the shareholders as protectors of their interests. In the present case, in the name of protection, a minority of such directors sought to frustrate, to the extent of millions of dollars, the entitlement of those whose interests they are supposed to champion and defend. It is a use and abuse of power Congress never intended. Congress mandated that mutual funds be operated and managed for the benefit of the shareholders, not for the benefit of those who manage them. Consistent with that congressional policy, plaintiffs must be given the opportunity to prosecute their claims of managerial abuse.

Defendants' assertion that the 1970 amendments to the Act point to an opposite result is erroneous. The Senate Report recommending passage makes it crystal clear that the purpose of the amendments was to expand the basis for liability of investment company directors and advisers and to increase judicial scrutiny of their activities generally, not only as regards management fees. Thus the

* *Compare* Del. Code tit. 8, §144 (1975).

Report states that mutual fund directors "will continue to have overall fiduciary duties . . . for the supervision of all the affairs of the fund." S. Rep. No. 91-184, *reprinted in* [1970] U.S. Code Cong. & Ad. News 4897, 4902-03. In this connection the standard for fiduciary liability was broadened by Section 36(a) to give the "courts" greater "ability . . . to deal flexibly and adequately with wrongdoing" (*id.* at 4931).

While the 1970 amendments strengthen the role of the independent directors vis-à-vis the adviser in certain respects, it is clear that Congress did not intend to diminish shareholder access to the courts to enforce violations of the Act nor to confer upon the independent directors the extraordinary power which defendants would attribute to them.

There is nothing inconsistent between strengthening the role of independent directors and the judicial enforcement of fiduciary standards. Chairman Williams of the Securities and Exchange Commission made this point recently when he told the Investment Company Institute on May 17, 1978 that

> The Investment Company Act exists to exert a force to counter the strong conflicts of interest inherent in the mutual fund structure. Heretofore, that force has been embodied by the Commission staff, i.e., it has been an external force. Unfortunately, as I have said, this external force has worked its way deeply into internal matters. It is now time for appropriate internal forces to be brought to bear. I believe that the independent directors, supported and prodded where necessary by an appropriate internal structure, by the courts and by the Commission, are the appropriate source of that force.

Williams, *A Challenge to Mutual Funds,* SEC News Release, May 17, 1978, p. 8.

Here, the Court of Appeals' decision clearly recognizes and supports the role of the courts as contemplated by Chairman Williams.* The Court of Appeals was entirely correct when it held

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* In the same address, Chairman Williams specifically rejected claims similar to those asserted here by defendants and the *amici curiae* that the decision of the Court of Appeals unduly restricted the powers and responsibilities of independent directors:

> Before moving on I should refer to another case which some have read as limiting the role of independent directors—namely *Lasker* v. *Burks* [CCH Fed. Sec. L. Rep. ¶96,282 (C.A. 2, 1978)]. As you know, in that case the Second Circuit found that the disinterested directors of a mutual fund could not effectuate the dismissal of a nonfrivolous derivative action against the fund's majority directors for breach of fiduciary duty. I do not believe that *Lasker* v. *Burks* should be read as restricting the responsibilities or the powers of independent directors. I believe the message is that substance will be considered over form, particularly in the unique circumstances presented by that case. The court found it was, for the benefit of those of you who have not read the opinion, ". . . asking too much of human nature to expect that the disinterested directors will view with the necessary objectivities the actions of their colleagues" when the independent directors are nominated by the majority directors, when their continued status depends on having satisfactory working arrangements with the majority directors, when management selects special counsel for the disinterested directors and when the majority directors face considerable personal liability in the event of an adverse decision.
>
> Moreover, the court was, obviously, very reluctant to raise any barriers to the statutory right of shareholders to sue under the Act for breaches of fiduciary duty. This latter consideration would not apply in ordinary cases involving the exercise of substantive business judgments. One may suspect that the court viewed the role of the independent director as being a check on management—not on the fund's shareholders.
>
> Nevertheless, a question which seems to pervade *Lasker* v. *Burks* is whether the directors there could be deemed truly independent. That question may legitimately be raised whenever directors are or appear to be more independent in form than they are in substance.

Id. at 12.

> We see nothing in the findings of Congress, the legislation regulating investment companies and their advisers, or in the decisions of the courts which suggests that under such circumstances disinterested directors, such as the five who acted here, have the power to terminate litigation brought by mutual fund stockholders against the fund's investment adviser and its majority directors for breach of their fiduciary duties. On the contrary, the findings of Congress, the statutory scheme, and the relevant case law persuade us that the statutorily disinterested directors of a registered investment company were never meant to have the final word in determining whether it is in the best interest of a mutual fund to press claims against their co-directors, and the adviser with which those directors are affiliated, for breach of fiduciary duties.
>
> . . .
>
> . . . It is asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the actions of their colleagues in a situation where an adverse decision would be likely to result in considerable expense and liability for the individuals concerned. Correspondingly, it cannot be expected that the public or the Fund's stockholders would believe that these five statutorily disinterested directors could act with that impartiality and objectivity which the public interest requires. It follows that disinterested directors of an investment company do not have the power to foreclose the continuation of non-

> frivolous litigation brought by shareholders against majority directors for breach of their fiduciary duties.

A. 43, 47 (footnote omitted).*

POINT II

A Minority of Directors Has Neither Power Nor Standing to Request the Termination of Nonfrivolous, Properly Commenced Derivative Litigation.

Defendants do not question the fact that this action has been properly commenced and that the demand requirements of Rule 23.1 have been fulfilled.** We know of no case where a validly commenced, nonfrivolous derivative action has been dismissed at the behest of a minority of a board of directors.

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* The concern expressed by defendants that the decision of the Court of Appeals somehow places mutual fund directors in a disadvantageous situation vis-à-vis other corporate directors is ill-founded. As In re Kauffman Mutual Fund Actions, 479 F.2d 257 (1st Cir.), *cert. denied,* 414 U.S. 857 (1973) demonstrates, a board having a disinterested majority of directors has the same power that directors of ordinary corporations have to prevent a derivative suit under the demand rule. What is sought here is not equality of treatment but favored treatment. As is shown *infra,* Point II, no case has ever permitted a minority to stand in the way of derivative litigation. Yet, that is what this Court is requested to sanction. See Bernstein, *An Extension of Business-Judgment 'Cloak',* N.Y. Law J., Mar. 28, 1977, at 1, col. 1, in which the author criticized an attempt similar to that used by defendants before the District Court as an unwarranted extension of the business judgment rule, not as regards mutual funds, but with respect to business corporations generally.

** The District Court in its first opinion noted, "[n]o demand was made on the Fund's Board of Directors in this case because plaintiffs alleged (and it is not disputed) that the majority of the Fund's directors are charged with wrongdoing and as such a demand would be futile" (A. 15).

It is well settled that an independent minority, even if a quorum, cannot prevent the commencement of a derivative action by asserting that a demand should have been made so that the minority could exercise its "business judgment." The uniform rule is that demand is excused whenever a majority of a board is charged with wrongdoing or is subject to the control of the alleged wrongdoer.*

The clear meaning of this well settled doctrine is that minority directors have no corporate power or authority to prevent or halt derivative litigation.

If sanctioned by this Court, the contrived procedure adopted in the present case by the Fund's board would unsettle the whole doctrine of shareholder demand and excuse therefrom. The purpose of the judicially-evolved criteria for excusing demand, which itself establishes that a board is disqualified from exercising business judgment, would be rendered meaningless. A shareholder who successfully pleaded futility of demand by virtue of a wrongdoing majority could enter the courthouse one day only to find himself turned out the next by a minority of the same board. This would accord defendants an escape hatch the attractiveness of which would increase commensurately

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* *See* Liboff v. Wolfson, 437 F.2d 121, 122 (5th Cir. 1971); Levitt v. Johnson, 334 F.2d 815, 817 (1st Cir. 1964), *cert. denied,* 379 U.S. 961 (1965); Swanson v. Traer, 249 F.2d 854, 856, 858-59 (7th Cir. 1957); Jannes v. Microwave Communications, Inc., 57 F.R.D. 18, 21 (N.D. Ill. 1972); Barr v. Wackman, 36 N.Y.2d 371, 379, 368 N.Y.S.2d 497, 505 (1975); Hall v. M.B. O'Reilly Realty & Investment Co., 306 Mo. 182, 196, 267 S.W. 407, 411 (1924); Tillis v. Brown, 154 Ala. 403, 406-07, 45 So. 589, 590 (1908); Sohland v. Baker, 15 Del. Ch. 431, 441, 141 A. 277, 281-82 (1927); Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit,* 73 Harv. L. Rev. 746, 747 (1960).

with the seriousness and substantially of their exposure to liability.

Thus, a wrongdoing majority could easily provide for the existence of independent directors, without ever losing control over the board. This is particularly so in controlled corporations, such as investment companies, where "[t]he power to place a slate of directors before the shareholders through the proxy mechanism is tantamount to appointment." Nutt, *A Study of Mutual Fund Independent Directors,* 120 U. Pa. L. Rev. 179, 215-16 (1971) (footnotes omitted). Defendant or affiliated directors could be rotated out of office until independent directors perceived as sympathetic became available to exercise business judgment. The potential for abuse would be enormous.

> The court should not cajole itself into believing that the members of a Board of Directors elected by the dominant and accused majority stockholder after accusations of wrongdoing have been made, were selected for membership on the Board to protect the interests of the minority stockholders and to assure a vigorous prosecution of effective litigation against the offending majority.

Cohen v. *Industrial Finance Corp.,* 44 F.Supp. 491, 494 (S.D.N.Y. 1942). *See also Meltzer* v. *Atlantic Research Corp.,* 330 F.2d 946, 949 (4th Cir.), *cert. denied,* 379 U.S. 841 (1964).*

* In the present case all members of the minority quorum were selected by defendants and became directors after the Fund's board (including the wrongdoers) had decided to defer consideration of what action, if any, should be taken against Anchor and others until after the Fund's suit against Goldman, Sachs was concluded (A. 157; Doc 10, Phillips Affd. § 7, June 19, 1973).

The procedure approved by the District Court would place impossible burdens on shareholders seeking to prevent dismissal of derivative actions by minority directors. As a practical matter, it would be almost impossible to ferret out unspoken loyalties and biases which motivated the decision of the directors vis-à-vis their majority colleagues. Particularly in the mutual fund industry, "tangible indications of bias on the part of the unaffiliated majority [here, minority] are rarely present. As stated in the legislative history, control of a mutual fund is the result of intangible factors arising out of the unique structure of the industry." *Boyko* v. *Reserve Fund, Inc.,* 68 F.R.D. 692, 696 (S.D.N.Y. 1975).

This Court has repeatedly observed: "'"The objection . . . rests in their tendency, not in what was done in the particular case . . . . The Court will not inquire what was done. If that should be improper, it probably would be hidden and would not appear."'" *SEC* v. *Capital Gains Research Bureau,* 375 U.S. 180, 196 n.50 (1963). If the procedure permitted by the District Court is sanctioned, the way will have been found for the destruction of shareholder redress of insider abuses.

A recent decision of the First Circuit illustrates the interrelationship of the principles discussed above. In *Untermeyer* v. *Fidelity Daily Income Trust,* 580 F.2d 22 (1st Cir. 1978) a derivative action was commenced on behalf of a mutual fund. The board consisted of four persons, two of whom were principals of the defendant investment adviser and two of whom were statutorily disinterested. The fund sought to dismiss the action for failure to comply with the demand requirements of Rule 23.1. In order to bolster their position, in a tactic similar to that employed here, the two disqualified directors stipulated that they would not vote on any demand to com-

mence an action made on the board by the shareholders. The court rejected this proposal, held that demand was excused and allowed the action to proceed.

Untermeyer proceeds upon the well established principle that a demand is required only where there is an independent majority. It rejects the notion that an independent minority can somehow be established and vested with the power of life and death over the law suit. It also rejects the correlative proposition that there should be an "extensive subjective inquiry" into the "independence" of the minority in favor of excusing demand in circumstances that are "identifiable, both promptly, and with some certainty and simplicity" (*id.* at 24).

The Second Circuit's ruling here provides such certainty: it simply prevents a minority from attempting to dismiss a derivative action whose commencement it could not have prevented.

The procedure attempted by the Fund's minority directors and rejected by the Court of Appeals is unprecedented. Cases cited by the defendants and the *amici curiae* are inapposite. Most involved the issue of shareholder demand and uphold the power of a board to act where the majority of directors are neither wrongdoers nor subject to the control of a wrongdoer. *E.g., United Copper Securities Co.* v. *Amalgamated Copper Co.*, 244 U.S. 261, 264 (1917); *Corbus* v. *Alaska Treadwell Mining Co.*, 187 U.S. 455, 463 (1903); *Cramer* v. *General Telephone & Electronics Corp.*, 582 F.2d 259, 274-75 (3d Cir. 1978); *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 264 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973); *Ash* v. *IBM*, 353 F.2d 491, 493 (3d Cir. 1965), *cert. denied*, 384 U.S. 927 (1966); *Swanson* v. *Traer*, 249 F.2d 854, 858-59 (7th Cir. 1957); *Bernstein* v. *Mediobanca Banca di Credito*, 69 F.R.D. 592, 596 (S.D. N.Y. 1974); *Independent Investor Protective League* v.

Saunders, 64 F.R.D. 564 (E.D. Pa. 1974); *Corey* v. *Independent Ice Co.*, 207 F. 459 (D. Mass. 1913); *Findley* v. *Garrett*, 109 Cal. App. 2d 166, 176, 240 P.2d 421, 427 (2d Dist. 1952); *McKee* v. *Rogers*, 18 Del. Ch. 81, 156 A. 91 (1931).

Others involved the business judgment rule as an affirmative defense to charges of directorial misconduct and have nothing to do with a board determination regarding the termination of derivative actions. *E.g., Davis* v. *Louisville Gas & Elec. Co.*, 16 Del. Ch. 157, 168-71, 142 A. 654, 658-60 (1928); *Ella M. Kelly & Wyndham, Inc.* v. *Bell*, 266 A.2d 878 (Del. 1970); *Moskowitz* v. *Bantrell*, 41 Del. Ch. 177, 180-82, 190 A.2d 749, 750-51 (1963); *Beard* v. *Elster*, 39 Del. Ch. 153, 164-65, 160 A.2d 731, 738-39 (1960); and *Puma* v. *Marriott*, 283 A.2d 693 (Del. Ch. 1971).

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There is no basis for defendants' assertion that the minority directors could terminate this litigation. The applicable authorities are to the contrary.

POINT III

Delaware Law Does Not Permit the Tactic Adopted by Defendants. Also, the Federal Courts Have Refused to Allow State Procedural Devices to Stand in the Way of Enforcement of Federal Rights.

A. *Delaware Law*

The law in Delaware, as elsewhere, is that where a majority of the directors are alleged wrongdoers or where an action, if brought by the corporation itself, would be subject to the control of the alleged wrongdoers, a demand on the board is excused and a shareholder may prosecute the claim on behalf of the corporation. *See McKee* v. *Rogers*, 18 Del. Ch. 81, 85-86, 156 A. 191, 193 (1931);

Satterthwaite v. *Eastern Bankers Corp.*, 17 Del. Ch. 310, 312, 154 A. 475, 476 (1931); *Sohland* v. *Baker*, 15 Del. Ch. 431, 441, 141 A. 277, 281-82 (1927). As stated by the Supreme Court of Delaware, "[t]he settled practice in Delaware has been that demand upon and refusal by the directors is sufficient, or, if the directors are disqualified to give redress, demand would be futile and is excused." *Mayer* v. *Adams*, 37 Del. Ch. 298, 304, 141 A.2d 458, 462 (1958). Under Delaware law, the Fund's board was disqualified and the minority directors were therefore without authority to act.

Thus the Delaware precedents are the same as under Federal Rule 23.1. There is no rational basis for denying to a minority the right to prevent commencement of a derivative action and thereafter granting to it the right to terminate the very same action. The same policy reasons which preclude exercise of business discretion by a minority in the first instance similarly preclude its exercise in the second instance: it would be highly inappropriate to place effective control over litigation in the hands of a board of directors run by those most hostile to the litigation's success. *See Hall* v. *M.B. O'Reilly Realty & Investment Co.*, 306 Mo. 182, 196, 267 S.W. 407, 411 (1924); *Tillis* v. *Brown*, 154 Ala. 403, 406-07, 45 So. 589, 590 (1908).

It is also clear that under Delaware law a board of directors may not sanction or ratify the perpetration of fraudulent or illegal acts by co-fiduciaries, such as are alleged in the present case. "It is settled law in Delaware that if the acts are ultra vires, illegal or fraudulent they may not be ratified." *Toebelman* v. *Missouri-Kansas Pipe Line Co.*, 130 F.2d 1016, 1022 (3d Cir. 1942). *See also Bennett* v. *Propp*, 41 Del. Ch. 14, 24-25, 187 A.2d 405, 411 (1962); *Keenan* v. *Eshleman*, 23 Del. Ch. 234, 2 A.2d 904 (1938).

The minority directors' decision in the instant case to seek to abort further judicial consideration of this matter is tantamount to an impermissible ratification under Delaware law. In *Mayer* v. *Adams*, 37 Del. Ch. 298, 304, 141 A.2d 458, 461 (1958) the Delaware Supreme Court said

> [A] decision not to press a claim for alleged fraud committed by the directors means, in effect, that the wrong cannot be remedied. It is conceded that the wrong cannot be ratified by the majority stockholders, but it is said that refusal to sue is a different thing from ratification. Strictly speaking, this is true, but the practical result is the same.

The same view is held by other state courts. "[I]n our opinion, neither a board of directors nor a majority of stockholders can, by ratification, make valid that which the corporation itself is by law prohibited from doing; nor can such ratification be accomplished indirectly under the guise of a refusal to bring an action." *Siegman* v. *Electric Vehicle Co.*, 72 N.J. Eq. 403, 409, 65 A. 910, 912 (1907). *See also Fisher* v. *National Mortgage Loan Co.*, 132 Neb. 185, 198-99, 271 N.W. 433, 440-41 (1937); *Continental Securities Co.* v. *Belmont*, 206 N.Y. 7, 17-19 (1912).*

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* As stated in Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 Harv. L. Rev. 746, 762 (1960)

> [W]hen the shareholders or directors have refused a demand to sue on a nonratifiable wrong, the plaintiff should always be allowed to proceed. . . . [I]t seems clear that a state's statutory or decisional law which holds certain wrongs nonratifiable evinces a policy which means to give the minority shareholder the power to redress these wrongs after directors and majority shareholders have declined to do so. . . . It is one thing to insist upon giving the primarily responsible parties an opportunity of bringing a suit, but quite another to allow them to prevent one when the policy of the law denies them that power.

Federal decisions are to the same effect. *See Brody* v. *Chemical Bank*, 482 F.2d 1111, 1114 (2d Cir.), *cert. denied*, 414 U.S. 1104 (1973); *Rogers* v. *American Can Co.*, 305 F.2d 297 (3d Cir. 1962); *Gottesman* v. *General Motors Corp.*, 268 F.2d 194, 197 (2d Cir. 1959).

In the instant case, the decision of the minority directors not to sue, if given effect, would not only constitute an improper ratification, but would also violate a strong Delaware policy favoring strict accountability of wrongdoing by corporate fiduciaries.

> The policy of the General Corporation law for many years has been to grant to the directors, and to the majority stockholders in certain matters, very broad powers to determine corporate management and policy. But, correlatively, the policy of our courts has always been to hold the directors and the majority stockholders to strict accountability for any breach of good faith in the exercise of these powers, and to permit any minority stockholders to seek redress in equity on behalf of the corporation for wrongs committed by the directors or by the majority stockholders.

Mayer v. *Adams*, 37 Del. Ch. 298, 304, 141 A.2d 458, 461 (1958).

Defendants have relied on the quorum provision of Delaware Corporation Law §141(b) and the Fund's bylaws as authority for the minority directors' decision to have this action dismissed. They now seek to add, for the first time, Delaware Corporation Law §144 as a source of legitimacy. Defendants cite no case law in connection with either provision suggesting the propriety of what

was done here.* There is no reason to believe that the Delaware courts would permit either provision to be used to alter strong Delaware policy concerning board disqualification in derivative suits, nonratification of fraud or illegality, and strict accountability by corporate fiduciaries for alleged wrongs. To the contrary

> [I]n situations in which a fiduciary duty is owed slavish compliance with a statutory requirement does not of itself make corporate actions immune from attack. . . .
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> . . . [A] court of equity is duty-bound to protect the interests of stockholders when they are threatened and to enforce the duties of fiduciaries in situations in which allegations of wrongdoing are made.

In re Arthur Treacher's Fish & Chips of Ft. Lauderdale, Inc., 386 A.2d 1162, 1166-67 (Del. Ch. 1978). *See also Young* v. *Valhi, Inc.*, 382 A.2d 1372, 1378 (Del. Ch. 1978) (denouncing the "use of technically correct but devious corporate actions" to defeat the rights of minority stockholders); *Schnell* v. *Chris-Craft Indus., Inc.*, 285 A.2d 437 (Del. 1971).

It is therefore quite clear that defendants' procedural gambit is not permitted by Delaware corporate law.

B. *Federal Cases*

Federal courts have evinced a policy of guarding litigants who seek to enforce rights under the federal secu-

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* In his treatise on Delaware corporate law, Professor Folk says with respect to Section 144 that "directors' actions are outside of the protection of the business judgment rule on finding 'fraud or gross abuse of discretion,'" as here alleged. E. L. FOLK, THE DELAWARE GENERAL CORPORATION LAW: A COMMENTARY AND ANALYSIS 76 (1972).

rities acts from being tossed out of court because of slavish adherence to procedural or technical niceties.

In *Drachman* v. *Harvey,* 453 F.2d 722, 728-30 (1971), *aff'd in relevant part upon rehearing in banc,* 453 F.2d 736 (2d Cir. 1972), defendants moved to dismiss a derivative action arising under Section 10(b) and Rule 10b-5 of the Securities Exchange Act on the grounds that neither Rule 23.1 nor the Exchange Act expressly conferred standing to sue upon shareholders whose stock was held in street name only, as opposed to registered owners. Defendants argued that the law of the state of incorporation, California, which permitted only registered owners to sue, should apply. The court of appeals refused to allow such technical arguments to defeat important federal regulatory policy and held that Federal Rule 23.1 standards, which afforded beneficial owners the right to sue, governed.

Drachman also clearly answers defendants' suggestion that Delaware law—which defendants have erroneously interpreted—can override or render nugatory important federal rights. *Drachman* counsels the opposite. The court noted

> The mission to protect completely and effectively the rights of the investing public under the Exchange Act cannot cease at the implication of a private right of action under §10(b) and Rule 10b-5. To permit diverse state law, reflecting conflicting or at least varying state policies, to define "who is a 'shareholder'" for purposes of a derivative action under §10(b) "would limit severely the scope of that section in an area comprehended by the statutory scheme," and in many cases might render a nullity the very right which federal law has sought to provide.

> . . . Congress scarcely would have intended such an incongruous result, given the comprehensive statutory remedial scheme of the Exchange Act passed for the protection of investors, nor would Congress have intended the creation of a broad remedial scheme, the effectiveness of which could be varied by the whims and vagaries of state law.

Id. at 729-30 (footnotes omitted). *See also In re Pittsburgh & Lake Erie Railroad Co. Securities & Antitrust Litigation,* 543 F.2d 1058 (3d Cir. 1976); *Meltzer* v. *Atlantic Research Corp.,* 330 F.2d 946, 948 (4th Cir. 1964), *cert. denied,* 379 U.S. 841 (1964); *McClure* v. *Borne Chemical Co.,* 292 F.2d 824, 831-35 (3d Cir.), *cert. denied,* 368 U.S. 939 (1961); *Fielding* v. *Allen,* 181 F.2d 163 (2d Cir. 1950).

The same result has been reached in cases arising under the Investment Company Act. In *Levitt* v. *Johnson,* 334 F.2d 815, 819 (1st Cir. 1964), *cert. denied,* 379 U.S. 961 (1965) the court held that a state law procedural requirement of demand on shareholders could not be used to prevent commencement of an action under the Act. The court said

> [T]he question is whether the act contemplated or impliedly forbade the application to the assertion of derivative rights of what the [district] court concluded to be a "strict Massachusetts rule." In this connection we note in section 1(b) a clear declaration of policy. The act is directed to "the national public interest and the interest of investors * * * adversely affected," and its "purposes * * * with which [its] provisions * * * shall be interpreted, are to mitigate and, *so far as is feasible, to eliminate* the conditions enumerated." (ital. suppl.) We do not see how it can be gainsaid that any substantial stiffening of the conditions precedent to

> the bringing of stockholders' suits above normal requirements would conflict with this broad declaration. The district court's reasoning that since the stockholder's right is a derivative one his right to bring suit must be controlled by the local law of the state of incorporation in the absence of an explicit congressional direction to the contrary negates the intendment of the act and underestimates the role to be played by the federal courts in the implementation of national regulatory legislation.

Id. (footnote omitted). *See also Rosenfeld* v. *Black*, 455 F.2d 1337, 1345 (2d Cir. 1971), *cert. denied*, 409 U.S. 802 (1972); *Chabot* v. *Empire Trust Co.*, 301 F.2d 458 (2d Cir. 1962).*

* * *

Neither Delaware law nor applicable federal considerations** permit the artifice attempted by defendants here.

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* Mr. Eisenberg, counsel in this case for the Investment Company Institute, has previously written with respect to the Investment Company Act, and Section 36 in particular, that "[s]hareholder rights in such a suit are based on federal law and should not be impeded by corporate or state devices designed to frustrate or unreasonably burden derivative suitors." Eisenberg & Lehr, *An Aspect of the Emerging "Federal Corporation Law": Directorial Responsibility Under the Investment Company Act of 1940*, 20 RUTGERS LAW REV. 181, 225 (1966) (footnotes omitted).

** If state restrictions on derivative actions were given free rein, mutual funds could "shop" for friendly places in which to incorporate and then use state law restrictions to fend-off derivative claims. Surely the broad remedial purposes of the federal acts involved do not permit such "forum shopping."

POINT IV

The Procedure Urged by Defendants and Adopted by the District Court Violates the Requirements of Rule 23.1. There Is No Need to Adopt the Unduly Complex Formulation Proposed by the SEC.

A. *The Requirements of Rule 23.1*

Rule 23.1 of the Federal Rules of Civil Procedure promulgated by this Court states that a derivative action "shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs."

It is well settled that judicial approval of the dismissal or compromise of a derivative action must be based upon a full exploration of the relevant circumstances, including the merits of the action. Generally, there must have been discovery on the merits. *See Saylor* v. *Lindsley*, 456 F.2d 896, 904-05 (2d Cir. 1972); *Weiss* v. *Chalker*, 55 F.R.D. 168, 169 (S.D.N.Y. 1972). The court must weigh the strength of plaintiff's claims and probability of success on the merits. *See Fricke* v. *Daylin, Inc.*, 66 F.R.D. 90, 97 (E.D.N.Y. 1975); *Cannon* v. *Texas Gulf Sulphur Co.*, 55 F.R.D. 308, 315-16 (S.D.N.Y. 1972). The court must then make an independent decision as to whether termination is fair and adequate to all concerned, including the absent shareholders on whose behalf the action has also been brought. *See Norman* v. *McKee*, 431 F.2d 769, 774 (9th Cir. 1970), *cert. denied*, 401 U.S. 912 (1971).* Defendants would ignore these funda-

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* Consistent with these criteria, Judge Fuld indicated in his report to the Fund's board, "[i]f . . . the Fund were actively to seek dismissal of the suit, current court procedures would appear to require a hearing substantially on its merits" (A. 111). Judge Fuld in his supplemental report modified this position slightly by

mental precepts of fairness by hiding behind the cloak of the business judgment rule.

Even in the few instances where a subsequently constituted independent majority has sought dismissal, the courts have uniformly refused to act as rubber stamps. Rather, in each instance, the court has carefully scrutinized the proposed "business judgment" of the new majority and then made its own independent determination based upon an evaluation of the merits of the action and the over-all fairness of the proposed action.

In *Birnbaum* v. *Birrell*, 17 F.R.D. 409 (S.D.N.Y. 1955) a derivative action had been commenced on behalf of Universal Labs, Inc. After commencement of the action, a new and concededly independent board of directors was seated. That new board, whose members controlled 62 percent of the stock, and the plaintiff reached a settlement with the wrongdoing defendants and applied to the court for dismissal pursuant to old Rule 23(c). Certain shareholders objected.

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saying that "at a minimum, the court would review the reasons for seeking dismissal and might consider, at least to some degree, the underlying merits of the derivative action" (A. 116). Defendants' took a contrary position below, arguing that Rule 23.1 was inapplicable and judicial evaluation of the merits unnecessary because the dismissal of this case was "involuntary." In support of this proposition, defendants cited cases involving the involuntary termination of derivative actions solely by operation of law. These cases are totally inapposite. *See* Katz v. Aspinwall, 342 F. Supp. 286 (N.D. Ala. 1971), *aff'd*, 459 F.2d 1045 (5th Cir.), *cert. denied*, 409 U.S. 1000 (1972) (suit dismissed because of dissolution of corporation); Daugherty v. Ball, 43 F.R.D. 329, 335 (C.D. Cal. 1967) (suit dismissed because corporation did not survive a merger); Marcus v. Textile Banking Co., 38 F.R.D. 185, 186 (S.D.N.Y. 1965) (suit dismissed as to defendant with respect to whom court lacked personal jurisdiction). Unlike the cited cases, defendants here seek dismissal based on the allegedly voluntary act of the minority directors as the purported representatives of the Fund.

Judge Edelstein refused to approve the settlement. Rather, he first directed that adequate notice be given to the stockholders and further directed that hearings be held as to the propriety of the settlement, including the adequacy of the settlement, the absence of collusion and the merits of the action. The court specifically rejected the notion that approval by the new board obviated the necessity of an appropriate hearing.

In *Berger* v. *Dyson*, 111 F.Supp. 533 (D.R.I. 1953) a settlement of a derivative action was proposed to the court. Substantial changes in the board had resulted in a quorum consisting of non-wrongdoers. Those new directors supported the proposed settlement. The court found it necessary to fully review the proposed settlement, including the merits of the action, before it would approve it. Concededly, the court believed that the board approval was a factor which it should consider. But it expressly rejected the position urged by defendants here: that the board determination was conclusive.

In *Denicke* v. *Anglo California Nat'l Bank*, 45 F.Supp. 524 (N.D. Cal. 1942), *aff'd*, 141 F.2d 285 (9th Cir.), *cert. denied*, 323 U.S. 739 (1944) a proposed compromise of derivative actions was before the courts. A change in management had occurred and no defendant was on the board at the time the compromise was proposed.

The courts nonetheless would not approve the settlement until there had been extensive hearings on all aspects of the proposed settlement and a careful consideration of the probability of success. The case is all the more significant because the board's approval of the settlement had been put to the stockholders, all of whom, except the two plaintiffs, had approved. Even this approval did not impel the courts to abdicate their judicial function.

In *Syracuse Television, Inc.* v. *Channel 9, Syracuse, Inc.*, 28 App. Div. 2d 638, 280 N.Y.S.2d 287 (4th Dep't 1967) a unanimous five judge court refused to permit a majority of directors and shareholders to end on-going derivative litigation despite their claim that they were acting reasonably, in good faith and with full knowledge of the facts. The Appellate Division stated that

> The allegations of the complaint of breach of duties imposed on officers and directors . . . merit a full and plenary trial and the issues should not be limited to whether the stockholders and directors ratified the actions of the defendants and voted to discontinue suits in good faith and with full knowledge of the facts.

In *Wolf* v. *Barkes*, 348 F.2d 994 (2d Cir.), *cert. denied*, 382 U.S. 941 (1965), plaintiff had commenced a derivative action challenging the compensation arrangements of four corporate employees. After commencement of the action, the four employees resigned and a proposed settlement was arrived at. The plaintiff sought to enjoin consummation of the settlement. No application for judicial approval of the settlement was before the court.

The court did not enjoin the board from proceeding but noted that all concerned proceeded at their own risk. The Second Circuit was also careful to point out that any request for judicial approval of the proposed settlement would require the usual, then Rule 23(c), hearing. The court's analysis of the *Denicke* and *Birbaum* cases is significant.

> In Denicke v. Anglo California Nat'l Bank, 141 F.2d 285 (9 Cir.), cert. denied, 323 U.S. 739, 65 S.Ct. 44, 89 L.Ed. 592 (1944), the corporation, which had come under new management, sought and obtained approval of a compromise under rule 23(c); so far as

> the case has any pertinence, this is only for its implicit holding that when a derivative suit is compromised in a district court, rule 23(c) must be complied with although the settlement has been instigated not by the derivative plaintiff but by the corporation acting under an independent board of directors. The same implicit holding appears in Birnbaum v. Birrell, 17 F.R.D. 409 (S.D.N.Y. 1955).

Id. at 997.

The cited cases amply demonstrate that even an independent majority of the board does not possess the raw power to dismiss a derivative action and that a full hearing, with all of its ancillary safeguards, is required. *See also* 3B Moore, Federal Practice §23.1.24[2] at p. 23.1-138.

We have found no decision prior to that of the District Court herein in which a minority of a board even attempted to dictate the dismissal of a validity commenced derivative action.*

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* Defendants have cited a number of cases (Pet. Br. 25n.) in support of their assertion that a minority of directors can terminate derivative litigation. These cases are inapposite. In Goodwin v. Castleton, 19 Wash.2d 748, 144 P.2d 725 (1944) a disinterested majority of directors and the shareholders approved a settlement, following which the court held a two-week trial before giving its approval. Alleghany Corp. v. Kirby, 344 F.2d 571 (2d Cir. 1965) was not a derivative action, but a direct action by the corporation. Two previously uninvolved shareholders attempted to compel the corporation to petition for a writ of *certiorari* from an adverse decision before the Court of Appeals. Their attempted intervention was held untimely. And in Brody v. Chemical Bank, 517 F.2d 932 (2d Cir. 1975) the filing of an amended complaint after an entirely new board had been appointed by court order was held to trigger a new demand requirement. In that case, unlike the case at bar, no board member was a defendant and there was no close relationship between the defendant and the "independent" directors. As we have shown, *Wolf* v. *Barkes*, *supra*, pp. 46-47 does not support defendants' but lends strong support to plaintiffs' position.

Following the District Court's decision in the present case, there have been two reported cases in which attempts were made to curtail derivative litigation under the imprimatur of business judgment exercised by a purportedly independent committee of minority directors advised by special counsel.

In *Gall* v. *Exxon,* 418 F.Supp. 508, 518 (S.D.N.Y. 1976) the court, noting that (unlike this case) there was not the slightest evidence of merit to plaintiff's claims, approved a procedure similar to the one here employed. The decision was rendered prior to the reversal by the Second Circuit in this case and was not appealed.

In *Auerbach* v. *Bennett,* 64 App. Div. 2d 98, 408 N.Y.S.2d 83 (2d Dep't 1978) a derivative action was commenced involving alleged improper bribes and kickbacks. After commencement of the action, three independent directors (a minority) were appointed to a Special Litigation Committee. Former Chief Judge Desmond of New York was retained and rendered a report in which he concluded that the derivative claims were without merit and that in any event it was not in the best interests of the corporation to prosecute the action. A motion for summary judgment was thereupon interposed by the corporation. At that time, there had been no discovery in the action.

In reversing dismissal of the action, a unanimous court refused to permit dismissal prior to the completion of pretrial discovery. The court rejected the notion "that the contours of the business judgment doctrine have been matched by the report of the committee and no further inquiry by an aggrieved stockholder should be entertained" (*id.* at 107, 408 N.Y.S.2d at 87). In this regard, the court first noted that "the hesitancy which might arise in outside directors by their investigation of fellow directors, especially when personal liability is at stake, is a consideration of moment" and then stated

> The business judgment doctrine should not be interpreted to stifle legitimate scrutiny by stockholders of decisions of management which, concededly, require investigation by outside directors and present ostensible situations of conflict of interest. Nor should the report of the outside directors be immune from scrutiny by an interpretation of the doctrine which compels the acceptance of the findings of the report on their face. In particular, summary judgment which ends a derivative action at the threshold, before the plaintiff had been afforded the opportunity of pretrial discovery and examination before trial, should not be the means of foreclosing a nonfrivolous action (*Lasker* v. *Burks,* 567 F.2d 1208). The limitation on the use of summary judgment, that it should not be granted when the facts are peculiarly within the knowledge of the moving party, applies with special force here. . . .

Id. at 107-08, 408 N.Y.S.2d at 88 (footnote omitted).

The court specifically approved the rationale of the Second Circuit in this case, rejected the argument that the decision was applicable only to investment companies and held that it was equally applicable to directors of ordinary business corporations (*id.* at 108 n.6, 408 N.Y.S.2d at 88 n.6).

The court concluded

> In short, the business judgment rule should not be so rigorously applied as to cut short practically at the pleading stage an apparently legitimate inquiry into a nonfrivolous claim of wrongdoing by directors and officers on the ground that a committee of disinterested directors, acting on the advice of independent counsel,

decided that the corporate interests will not be promoted by a derivative action.

Id. at 108, 408 N.Y.S.2d at 88.

Auerbach clearly stands for the propositions (a) that minority directors lack the naked power to terminate on-going derivative actions; (b) that discovery is required to elucidate all of the facts, including the merits; and (c) that full judicial inquiry is required.*

It is therefore apparent that dismissal of a properly commenced derivative action requires consideration of the relevant factors pursuant to Rule 23.1. As is shown in Point V, even if a hearing had been held in the present case, relevant considerations would require that this action be permitted to continue.

B. *The SEC's Proposal Should Not Be Adopted*

The well charted course offered by Rule 23.1 demonstrates that there is no need to adopt the SEC's complex proposal. That proposal would wreak havoc with the traditional role of the courts in derivative litigations; it would also result in extensive, time-consuming and litigation-delaying hearings at the behest of minority directors.**

* A similar result is indicated by Elgin Nat. Indus., Inc. v. Zale Corp., 71 Misc.2d 468, 336 N.Y.S.2d 275 (Sup. Ct. 1972). There a derivative action was brought on behalf of Elgin. Thereafter, the court permitted Elgin to take over the action based upon a finding that the corporation was controlled by independent directors. Those independent directors then sought to discontinue the action. The court directed that appropriate notice be sent to all stockholders and that a formal judicial hearing be held because "the action should [not] be discontinued without affording the stockholders the opportunity to further investigate the merits and to present any testimony they wish to present on the issue of discontinuance" (71 Misc.2d at 470, 336 N.Y.S.2d at 277).

** The SEC has also argued that two of the three prongs of its impractical test have been satisfied (SEC Br. 23-4). This erroneous contention will be dealt with in Point V.

The SEC's proposal is based upon a number of ill-conceived and misconceived notions:

1. A basic premise of the SEC's position is that, generally speaking, corporate boards possess the absolute power to terminate on-going derivative litigation. As has been shown, this fundamental premise is incorrect.

2. The SEC's test of "business judgment" would revolve solely upon the information before the board at the time of its decision. There is nothing in the SEC's test to assure that adequate—or even honest—information would be supplied to the board.*

3. The SEC suggests a review standard with respect to board action similar to that when administrative action is judicially reviewed. Nowhere, however, does the SEC provide for any mechanism to afford the plaintiffs the safeguards guaranteed by the Administrative Procedure Act: (a) impartial arbiters of the facts—not handpicked individuals paid by, subservient to, or subject to removal by the wrongdoers (*see Commonwealth Coatings Corp.* v. *Continental Casualty Corp.*, 393 U.S. 145 (1968), *reh. denied*, 393 U.S. 1112 (1969)); (b) due notice to plaintiffs of the scope of the inquiry—not notice contained in papers moving to dismiss; and (c) the right to call witnesses and present evidence—not a limited inquiry which prevents all discovery on the merits.

4. The notion that the hearing before the court should be akin to review of administrative determinations also

* Thus, in the present case there is no indication that the information given to Judge Fuld or the minority directors was given under oath (A. 82). There also is no way for plaintiffs to ascertain whether defendants withheld information. How can adequacy of disclosure possibly be tested without the safeguards of sworn testimony taken in an adversary context?

overlooks the fact that the courts, not directors or their counsel, are uniquely qualified to determine the validity of claims asserted in a litigation. *Marx & Co.* v. *Diners Club, Inc.*, 550 F.2d 505, 509-12 (2d Cir.), *cert. denied,* 434 U.S. 861 (1977).

Further, in derivative suits the court is charged with a duty to protect the interests of absent shareholders. That responsibility cannot be delegated to the selected representatives of the wrongdoing defendants.

Heretofore, the demand and futility criteria in Rule 23.1 have been used by the courts to determine on the pleadings whether or not a board of directors is competent to exercise business judgment with respect to the wrongs alleged. *See Untermeyer* v. *Fidelity Daily Income Trust,* 580 F.2d 22, 24 (1st Cir. 1978); *In re Kauffman Mutual Fund Actions,* 479 F.2d 257, 263 (1st Cir.), *cert. denied,* 414 U.S. 857 (1973); *Papilsky* v. *Berndt,* 59 F.R.D. 95, 98 (S.D.N.Y. 1973), *appeal dismissed,* 503 F.2d 554 (2d Cir.), *cert. denied,* 419 U.S. 1048 (1974). Under the SEC's proposed rule, that simple procedure for testing a board's competence at the threshold of litigation would be supplanted by a costly, burdensome and complex preliminary evidentiary inquiry into the Gordian issues of independence, adequacy of disclosure and reasonableness of the decision.*

The SEC's assertion that *Tannenbaum* v. *Zeller,* 552 F.2d 402 (2d Cir.), *cert. denied,* 434 U.S. 934 (1977) supports

* In the present case, for example, approximately 3½ years elapsed between the time the minority directors agreed to look into the matter and the reversal by the Court of Appeals. Approximately 1,000 pages of deposition testimony were taken. There were three adjudicated motions and opinions by the District Court, one appeal and a request for rehearing in banc all addressing the single issue of whether the minority directors were competent to dismiss this action. The time and cost factors have been enormous to all concerned, and defendants have not to this day answered the complaint.

the cumbersome preliminary procedure proposed here is without merit.

In *Tannenbaum,* as in *Fogel* v. *Chestnutt,* 533 F.2d 731 (2d Cir. 1975), *cert. denied,* 429 U.S. 824 (1976), the issue before the court was whether an investment adviser failed to make full and adequate disclosure to the independent directors regarding the possibility of recapturing brokerage commissions. Whether to recapture was a matter of business judgment and failure to recapture in and of itself did not constitute a violation of law. The gravamen of the offense charged in those cases was management's failure to disclose adequately to the independent directors information concerning the possibility of recapture.

As proposed in the *Tannenbaum* case, the SEC rule was intended to add a *more stringent test* than that afforded by the traditional business judgment rule. Thus, if defendants could prove the independent directors (i) were in fact independent, (ii) were fully informed, and (iii) made a reasonable decision not to recapture, they would be found innocent of the charge of nondisclosure. In these cases the merits of the litigation involved the adequacy of disclosure to the independent directors and presumably that matter would have been the subject of exploration by pretrial disclosure. Here, the SEC would prevent any testing of the adequacy of disclosure in the traditional litigative setting.

Fogel and *Tannenbaum* are concerned with determining whether directorial discretion has been properly exercised in areas where discretion is vested in the directors. Here, the complaint charges fraud and illegality. As stated in *Arthur Lipper Corp.* v. *SEC,* 547 F.2d 171, 179 (2d Cir. 1976), *cert. denied,* 434 U.S. 1009 (1978), "it is not within the competence of a board of directors of an investment

company to sanction the perpetration of a fraud by the manager. . . . Indeed, it would seem that only a unanimous shareholder vote could ratify a fraud of this type even if approved by directors" (citations omitted). This decision militates against adoption of the SEC's proposal. *See also Tannenbaum* v. *Zeller, supra,* 552 F.2d at 429 n.31; *Fogel* v. *Chestnutt, supra,* 533 F.2d at 750.

The SEC acknowledges in its brief that managers of financial institutions "are under an especially high standard of fiduciary care toward the money they manage" (SEC Br. 18n.13).* In utter perversion of this principle the SEC now seeks to hold such managers to a lesser standard of judicial review than is otherwise applicable under Rule 23.1. It seeks also to brush aside Congress' mandate that investment companies be operated for the benefit of the shareholders, not for the benefit of the directors or the investment adviser. The SEC's proposed rule would create a privileged managerial class, able, as was done here, to handpick its own judge and jury, the forum and manner of trial and the evidence to be produced for consideration. There is no parallel in our jurisprudence.

The SEC's suggested procedure is costly, burdensome, unnecessary and unfair. It would disrupt and supplant the operation of Rule 23.1 and would overrule, in principle, hundreds, if not thousands, of judicial decisions concerning the disqualification of boards of directors under similar circumstances.

No court would approve a dismissal of this case under Rule 23.1 at the instance of plaintiffs without a full inquiry. This Court should not permit its dismissal at the instance of defendants acting through handpicked minority

* See cases cited at pp. 66-67, *infra*.

directors. Reason, logic, the law and fairness require that the SEC's position not be adopted in the present case.*

POINT V

There Is No Need for Any Further Proceedings as to the "Propriety" of the Action of the Minority. An Examination of the Relevant Factors Conclusively Demonstrates That This Action Should Proceed and Be Litigated on the Merits.

Both Rule 23.1 and the SEC's proposed procedure call for an examination of various circumstances in order to permit a court to determine whether a derivative action should be dismissed.** An examination of the relevant factors in this case conclusively demonstrates that it cannot be dismissed because:

A. The minority quorum was not independent;

B. The action has merit;

C. The minority quorum was not fully and fairly informed of all relevant facts; and

D. Continued prosecution of the action cannot possibly injure the Fund.

This action was commenced in February 1973. There has been no discovery on the merits—indeed, defendants have not even answered. It is time that defendants face up to the merits.

* Rule 23.1 itself provides an adequate framework for the termination of suits in which continued litigation poses a threat of imminent harm to the corporation. In such cases the District Court can decide whether termination is fair and in the interests of the absent shareholders, as it does in all Rule 23.1 dismissals and compromises.

** As noted in Point IV, the defendants and the SEC would ignore the requirements of Rule 23.1 by preventing any discovery on the merits.

A. The Minority Quorum Was Not Independent

The evidence overwhelmingly establishes the lack of independence of the minority. They were chosen to serve on the boards of the Anchor Group of Mutual Funds by Anchor and the majority directors, who could have removed them at will. They were all selected after the events complained of here.* They also had personal relationships with one or more of the defendants. In addition, Anchor completely dominated the Fund at all levels of operation and occupied all strategic managerial positions. Under these circumstances, independence was impossible.

The following chart shows the composition of the Directors' Qualifications Committee, which screened and recommended each member of the disinterested quorum for nomination as a Fund director. As is evident, in every instance, except for the selection of Mr. Kendall, the Committee consisted totally of defendants. In Mr. Kendall's case, two of the three members of the Committee were defendants.

Minority Directors	*Initially Recommended By*	*Members of Directors Qualifications Committee*
1. Laun	Defendant Phillips	Defendant Haire Defendant Burks Defendant Phillips

* As we have indicated, at a board meeting held on October 28, 1970 the Fund directors decided to sue Goldman, Sachs and to defer any decision as to what action should be taken against Anchor and others (A. 157; Doc. 10, Phillips Affid. ¶7, June 19, 1973). Two of the minority were seated after that resolution and three more after commencement of this action in February 1973.

Minority Directors	*Initially Recommended By*	*Members of Directors Qualifications Committee*
2. O'Connor	Defendant Haire	Defendant Haire Defendant Burks Defendant Phillips
3. Stephens	Defendant Hopkins	Defendant Haire Defendant Kemmerer Defendant Hopkins
4. Robichaud	O'Connor, after prior approval by Defendant Haire	Defendant Haire Defendant Kemmerer Defendant Hopkins
5. Kendall	Defendant Haire	Defendant Haire Defendant Kemmerer Defendant Robichaud

(Doc. 84, Pls. Exhs. 5, 6, 13, 14, 21 and 22; Laun Tr. 80; O'Connor Tr. 3, 88-89; Stephens Tr. 7; Kendall Tr. 33). Mr. Haire, Anchor's Chairman, was in each instance a member of the Committee, which always operated by consensus (Haire Tr. 179, 298-99). All votes were unanimous, which, in effect, gave Anchor a veto as to who would be "independent" directors.

The next chart shows the composition of the Fund's board at the time each of the quorum directors were nominated for membership on the board.* Again, defendants' domination of the board is apparent.

* Mr. Laun was elected directly by the board.

Minority Directors	*Members of the Nominating Board of Directors*
1. Laun	Defendant Haire
	Defendant Burr
	Defendant Hutchison
	Defendant Phillips
	Defendant Kemmerer
	Defendant Burks
	Defendant Hopkins
	Defendant Monroney
	Defendant Wade
2. O'Connor	Defendant Haire
	Defendant Burr
	Defendant Hutchison
	Defendant Kemmerer
	Defendant Burks
	Defendant Hopkins
	Defendant Wade
	Mr. Martin—President of Anchor
	Mr. Laun
3. Stephens	Defendant Haire
	Defendant Burr
	Defendant Hutchison
	Defendant Phillips
	Defendant Kemmerer
	Defendant Hopkins
	Defendant Wade
	Mr. Martin—President of Anchor
	Mr. Laun
	Mrs. O'Connor
4. Robichaud	Defendant Haire
	Defendant Burr
	Defendant Hutchison

Minority Directors	*Members of the Nominating Board of Directors*
	Defendant Phillips
	Defendant Kemmerer
	Defendant Hopkins
	Defendant Wade
	Mr. Martin—President of Anchor
	Mr. Laun
	Mrs. O'Connor
	Mr. Taylor
5. Kendall	Defendant Haire*
	Defendant Burr*
	Defendant Hutchison*
	Defendant Kemmerer
	Defendant Phillips
	Mr. Martin—President of Anchor*
	Mr. Laun
	Mrs. O'Connor
	Mr. Stephens
	Ms. Robichaud

Doc. 76, Tersigni Affid., Sept. 20, 1976, Exhs. B, C, D, E, F.

In addition to defendants' control of the selection and nominating process, the quorum directors had a long history of social and business relationships with a number of defendants. Several lived in the same community and worked together with defendants in civic matters. Four of

* The four Anchor-affiliated directors abstained from voting on Mr. Kendall's nomination. Mr. Haire, however, had recommended Mr. Kendall in the first instance and had voted for him as a member of the Directors' Qualifications Committee (Haire Tr. 216; Kendall Tr. 32-33). Why these abstentions occurred remains an interesting question. They apparently were a belated effort to effectuate a semblance of independence.

the quorum directors testified that they considered one or more of the defendants to be a friend (Haire Tr. 145-47; Kendall Tr. 8, 12-14, 17-21, 71, 73; Laun Tr. 78-80; O'Connor Tr. 3-12; Stephens Tr. 7-8, 12-15). The minority directors and the defendants also worked and associated with each other at least once a month as members of the various Anchor Group's boards, for which they were paid \$11,000 to \$13,000 a year.

Based on the foregoing, the Court of Appeals determined that there was a symbiotic relationship between the Fund and Anchor and that irrespective of good faith, the minority directors could not have viewed the acts of their defendant colleagues with objectivity or impartiality (A. 46-47, 48 n.14). The facts set forth above fully support those findings and conclusively demonstrate a lack of independence and impartiality.

Numerous authorities establish that, under the circumstances of this case, the minority directors are not disinterested or independent. The process of selecting the minority directors followed the usual pattern of control in the mutual fund industry. "[O]bviously, you know and I know that if you are choosing an unaffiliated director or an independent director you are not going to choose anybody who is going to be too hard on you. You are going to tend to pick a friend of yours . . . ." *Conference on Mutual Funds*, 115 U. Pa. L. Rev. 662, 739 (1967) (remarks of Abraham L. Pomerantz, Esq.). "[T]hrough either informal suggestions or the veto often given the adviser's representatives on the committee [Mr. Haire], the selection of independent directors effectively remains in the adviser's hands." Nutt, *A Study of Mutual Fund Independent Directors*, 120 U. Pa. L. Rev. 179, 216 (1971). *See also* Wharton School of Finance & Commerce, *A Study of Mutual*

Funds, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 465-66 (1962).

As Chairman Williams told the Investment Company Institute on May 17, 1978: "No matter how independent a director may be in fact, there will always be a question if he is selected by management." Williams, *A Challenge To Mutual Funds*, SEC News Release, May 17, 1978, p. 9.

In *Fogel* v. *Chestnutt*, 533 F.2d 731, 750 (2d Cir. 1975), *cert. denied*, 429 U.S. 824 (1976), the Second Circuit observed, "[u]nder the best of circumstances there is bound to be doubt about the independence of the 'unaffiliated' or now the 'disinterested' director . . . ."

In *Tannenbaum* v. *Zeller*, 552 F.2d 402 (2d Cir.), *cert. denied*, 434 U.S. 934 (1977), the SEC filed an *amicus* brief in which it stated: "Our experience is that rarely are the independent directors truly independent of domination by the adviser" (p. 37).*

Theodore A. Levine, the SEC's Assistant Director of the Division of Enforcement, has stated with respect to independent audit committees that "[t]he Commission might consider independence tainted if 'outside' officials are members of the same clubs, went to the same schools or lived in the same neighborhoods as 'inside directors.'" BNA, Sec. Reg. L. Rep., *News & Comment*, May 4, 1977, p. A-5. The same considerations clearly point to the fact that the minority here was not independent.

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* How the SEC can conclude on the present record that the quorum directors were independent is a mystery and is belied by its more candid position in *Tannenbaum*. There is nothing in the record here to take this case out of the Commission's prior experience. How handpicked minority directors can possibly be independent nowhere is explained.

In an affidavit filed with the District Court, James C. Sargent, a former Commissioner of the SEC, expressed the view that a quorum of outside directors comprising a minority of a mutual fund's board of directors cannot be considered independent regarding a decision which would adversely affect the economic interests of majority directors (A. 153-54).*

These considerations are not unique to mutual funds. It has long been recognized that minority directors cannot be deemed independent with respect to charges of wrongdoing asserted against the majority.** Similarly, directors are not independent or disinterested where they are the nominees of a wrongdoer or where the wrongdoer dominates the management and operation of the corporation or controls the elective process.***

The minority directors in this case simply did not possess the requisite degree of independence necessary to permit them to attempt to exculpate the majority.

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* In a mutual fund control of the board obviously carries full control of the proxy machinery and the corporation. Wharton School of Finance & Commerce, *A Study of Mutual Funds*, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 64 (1962); Securities & Exchange Commission, *Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 129-30 (1966).

** *See* Point II, *supra*.

*** *See* Delaware & Hudson Co. v. Albany & Susquehanna R.R. Co., 213 U.S. 435, 443, 450-51 (1909); de Haas v. Empire Petroleum Co., 286 F.Supp. 809, 814 (D. Colo. 1968), *aff'd*, 435 F.2d 1223, 1228 (10th Cir. 1970); Kaminsky v. Abrams, 281 F.Supp. 501, 503 (S.D.N.Y. 1968); Heilbrunn v. Hanover Equities Corp., 259 F.Supp. 936, 939 (S.D.N.Y. 1966); Craftsman Fin. & Mortgage Co. v. Brown, 64 F.Supp. 168, 175 (S.D.N.Y. 1945); Ripley v. International Railways of Cent. America, 8 App. Div.2d 310, 317 (1st Dep't 1959), *aff'd*, 8 N.Y.2d 430 (1960).

B. *The Action Has Merit*

An examination of the facts at bar and the relevant authorities demonstrates that the Court of Appeals was undoubtedly correct in determining that this action has merit.

Judge Fuld repeatedly expressed his inability to find relevant authority on the issue of whether an investment adviser is required to make an independent investigation and analysis prior to causing an investment fund to purchase securities (A. 96, 97, 100, 102, 108). Unfortunately, he overlooked *Matter of Winfield & Co.*, [1971-72 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶78,530, p. 81,147 (SEC 1972), where the Securities and Exchange Commission expressly held that such a failure violated the antifraud provisions of the federal securities laws and Section 36 of the Investment Company Act. The Commission said

> The record shows that in many cases Meid relied on unsubstantiated representations of other persons, described by him as "research sources," and that such persons frequently had a substantial economic interest in the offering or the issuer of such securities. Adviser and Meid had an obligation to make a reasonable investigation before causing the Fund to purchase any securities.

Analogizing the adviser's duties to the duty of broker-dealers to make such investigations, the Commission stated

> The obligation of a broker-dealer in this area arises under the antifraud provisions of the federal securities laws. Those provisions are, of course, applicable as well to an investment adviser of a registered investment company. Moreover, when registered investment companies are involved, the obligation also is

imposed by Sections 15 and 36 of the Investment Company Act.

Id. at p. 81,147 n.14. *See also* Securities Act Release No. 4445, [1961-64 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶76,820, p. 81,068 (1962).

Judge Fuld, moreover, overlooked the line of cases in which the courts have held that broker-dealers have a duty to investigate and may not blindly accept the recommendations of others who are economically self-interested. *See, e.g., Hanly* v. *SEC,* 415 F.2d 589, 595-96 (2d Cir. 1969). Certainly, if broker-dealers have a duty to make an independent investigation, so must investment advisers, who receive millions of dollars in fees annually to make investment decisions for absent shareholders.

Judge Fuld also concluded that the principal adverse information concerning Penn Central was not available until April 23, 1970 and that Anchor probably could not have sold the paper at that time, even had it attempted to do so (A. 103). Yet, Mr. Haire disclosed at the December 18, 1974 meeting, after Judge Fuld had written his report, that Goldman, Sachs was repurchasing Penn Central paper up to May 1, 1970 (A. 121-22). Anchor made no effort to sell the paper until May 18, 1970, by which time it was too late (A. 87).*

* Reported decisions have found that adverse financial information concerning Penn Central was publicly available well before the time fixed by Judge Fuld. In Welch Foods Inc. v. Goldman, Sachs & Co., 398 F.Supp. 1393, 1398 (S.D.N.Y. 1974) the court said, "[e]nough objective data was known concerning Penn Central in early 1970 to lead a reasonable observer to conclude that the commercial paper was not prime, and indeed the issuer became insolvent very shortly thereafter." Other reported cases have depicted the continuing decline of Penn Central throughout 1969 and into early 1970 by virtue of its large financial losses "widely reported in the financial press." *See* University Hill Foundation v. Goldman, Sachs & Co., 422 F.Supp. 879, 889-90

Judge Fuld's conclusion that the Fund's directors were not liable was based in large measure on his conclusion that Anchor was not liable (A. 107-08). Yet it is quite clear that Anchor is liable. The Fund directors were grossly negligent in failing to oversee the Fund's investment policies and the procedures employed by Anchor.

Mr. Laun testified that Fund directors had an obligation to review Anchor's investment decisions (Laun Tr. 83). Mr. Kendall similarly testified that an investment adviser was obligated to perform research as part of its services and that the Fund directors "have a responsibility for the quality of the research . . ." (Kendall Tr. 44, 45-49, 212-13). These self-admitted obligations were ignored by the directors.

Judge Fuld's report further suggests that the directors are not liable because they were ignorant of the fact that Anchor had instituted a change in procedure and had begun purchasing dealer paper (A. 108). The report also establishes that Anchor was doing no independent investigation or review of the companies whose paper was being purchased and that short-term investments were lumped together and not separately identified in monthly reports reviewed by the directors (A. 108, 122-23). As a result, the directors didn't even know what purchases were being made and did nothing to inform themselves as to any of these matters. Such all-encompassing ignorance by the board presents a classic situation for the imposition of liability.

In *Stern* v. *Lucy Webb Hayes National Training School,* 381 F.Supp. 1003, 1013-14 (D.D.C. 1974) the court noted

(S.D.N.Y. 1976); Franklin Sav. Bank v. Levy, 551 F.2d 521, 523 (2d Cir. 1977). *See also* Staff Report of the Securities and Exchange Commission, *The Financial Collapse of the Penn Central Company* 11-14, 279, 282 (August 1972).

A corporate director, on the other hand, may delegate his investment responsibility to fellow directors, corporate officers, or even outsiders, but he must continue to exercise general supervision over the activities of his delegates. . . .

Total abdication of the supervisory role, however, is improper even under traditional corporate principles. A director who fails to acquire the information necessary to supervise investment policy or consistently fails even to attend the meetings at which such policies are considered has violated his fiduciary duty to the corporation. 3 Fletcher Cyc. Corp. (Perm.Ed. Rev. 1965) § 1091 (1965). While a director is, of course, permitted to rely upon the expertise of those to whom he has delegated investment responsibility, such reliance is a tool for interpreting the delegate's reports, not an excuse for dispensing with or ignoring such reports. *See* Heit v. Bixby, 276 F.Supp. 217, 231 (E. D.Mo. 1967). A director whose failure to supervise permits negligent mismanagement by others to go unchecked has committed an independent wrong against the corporation . . . ."

See also Mann v. *Commonwealth Bond Corp.*, 27 F.Supp. 315 (S.D.N.Y. 1938).

It is well established that directors of financial institutions are held to a higher standard of care than directors of ordinary business corporations. *See Goodwin* v. *Simpson*, 292 Mass. 148, 150, 197 N.E. 628, 630 (1935); *O'Connor* v. *First National Investors' Corp.*, 163 Va. 908, 919-27, 177 S.E. 852, 857-60 (1935); *Hun* v. *Cary*, 82 N.Y. 65, 71 (1880).*

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* *See also* Eisenberg & Lehr, *An Aspect of the Emerging "Federal Corporation Law": Directorial Responsibility Under the Investment Company Act of 1940*, 20 Rutgers L. Rev. 181, 188-89 (1966).

In *Brown* v. *Bullock*, 194 F.Supp. 207, 238 n.1 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961) the court said that Section 36 of the Investment Company Act imposes a fiduciary duty on investment company directors and advisers regarding the handling of other people's money. Here, the directors violated not only higher standards but the most basic obligation which they owed to the stockholders.

The Fund directors are also liable for negligence under Delaware law. In *Lutz* v. *Boas*, 39 Del. Ch. 585, 610, 171 A.2d 381, 396 (1961), the court stated

> I am satisfied that these directors are liable because I think it is clear that had they discharged their responsibilities as to general supervision they would have discovered these violations of Funds' investment policy. It is evident that the negligence of these directors can be considered a proximate cause of this loss to Funds.

See also Graham v. *Allis-Chalmers Manufacturing Co.*, 41 Del. Ch. 78, 84, 188 A.2d 125, 130 (1963); Fletcher, Cyclopedia Corporations §1019, p. 569 (Perm. ed. 1975).

The pending action is most certainly meritorious. Yet, Judge Fuld's contrary opinion was a key factor in leading the minority to seek dismissal of this action. As Mrs. O'Connor testified: "My basis for this decision was that Judge Fuld's opinion had brought out that Anchor and the director defendants were not guilty and that there was not merit in the case. And that was my decision" (O'Connor Tr. 74). *See also* Robichaud Tr. 118-19; Laun Tr. 33; A. 77-80, 131.

Thus, the fundamental factor on which the minority directors based their decision, that this action has no merit, was patently erroneous. As indicated by the Court of

Appeals, the pending action has substantial merit (A. 40-41, 43).

C. *The Minority Quorum Was Not Fully and Fairly Informed of All Relevant Facts*

Plaintiffs were not granted the opportunity to test whether the disclosures made to the minority directors and Judge Fuld were fair and adequate. Nevertheless, the limited record clearly reveals a total absence of candor. Obviously, this was to be expected in view of the fact that it was the defendants themselves who were "disclosing" the relevant facts.

1. Mr. Haire's Misrepresentations to the Minority Directors

The minority directors were misled into reaching the incredible belief that unless they attempted to terminate this action, they would have to terminate the Fund's advisory contract with Anchor (A. 77-78). For this reason they asked Mr. Souther, the Fund's litigation counsel, to prepare a memorandum outlining the procedures for changing advisers, which he did (A. 77, 135). The origin of their misinformation is directly traceable to Mr. Haire.

At the Fund's December 18, 1974 board meeting, Haire told the minority directors of the adverse impact on Anchor if this case were not terminated. In this connection he referred to the "substantial distraction to Anchor," the adverse effect on its ability "to attract and retain . . . highly qualified personnel" and its inability to satisfy a judgment in the full amount of the claims (A. 125-26).

There is no doubt that Haire's statements strongly influenced the minority directors. They concluded that an "adversary relationship" would develop between the Fund and Anchor if the case went forward and that the "serious distraction of Anchor's personnel . . . would leave us no

practical alternative but to remove Anchor as an investment adviser" (A. 77-78).

The record fails to disclose why this assertion was made to the minority directors in light of the fact that a number of prior derivative actions against Anchor had led to no such dislocation. *E.g.*, *Gordon* v. *Fundamental Investors, Inc.*, 362 F.Supp. 41 (S.D.N.Y 1973); *Weiss* v. *Chalker*, 55 F.R.D. 168 (S.D.N.Y. 1972).

At his deposition, Haire substantially altered his views. He testified, "I have never at any time had any doubt that we could continue to effectively serve the fund . . ." (Haire Tr. 84, 283). He further testified that he never even considered the possibility of Anchor's advisory contract being terminated if the action went forward and that stockholder actions were simply a part of doing business in the mutual fund industry (Haire Tr. 85, 151).

The minority directors were not only misled, but their purported business reasons were disaffirmed by Mr. Haire, a principal defendant in the case.

Mr. Haire also told the minority directors at the December 18, 1974 board meeting that he believed Anchor's investment guidelines had been followed in connection with the Penn Central purchases (A. 121-22). The directors relied upon this information as a basis for their decision (A. 131).* Judge Fuld's report establishes without ques-

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* Mr. Laun testified

Q. Do you know whether Anchor made any investigation or analysis?

A. I know of no independent investigation or analysis that was made.

Q. Do you consider that relevant to whether or not they should be sued?

[Objection by counsel]

tion that two of the three guidelines were violated, including the failure to obtain a buy-back commitment from Goldman, Sachs (A. 84, 109, 113). Here again, the minority directors were affirmatively misled by Mr. Haire. It certainly cannot be said that they were fully and fairly informed.

As stated in ***Papilsky*** v. ***Berndt***, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,627, p. 90,133 (S.D. N.Y. 1976), "the picture that emerges is one of Lord, Abbett [the adviser] funneling to the Board business reasons why one or another method of recapture would be a poor idea—business reasons that, we now are told, should not have precluded recapture . . . ." *See also Fogel* v. *Chestnutt*, 533 F.2d 731, 750 (2d Cir. 1975), *cert. denied*, 429 U.S. 824 (1976).

2. The Biased Participation of Mr. Souther

Full disclosure to the disinterested directors was further impaired because they were advised by the Fund's litigation counsel, Eugene P. Souther, an "interested person" under the Investment Company Act.*

At the quorum's December 18, 1974 meeting, Mr. Souther told the directors, in effect, why the Fund would have nothing to gain if the action went forward. The minutes of the meeting, which he prepared, state

> The Chairman then called upon Mr. Souther, who discussed the practical implications of following each of the alternatives available to the Fund and the nature and extent of the proceedings each alternative would entail. Mr. Souther advised the Board that it could consider the possibility that as a result of retention by the Fund of a 73.75% interest in the notes under its settlement with Goldman, Sachs, the Fund might recover some additional amount in the reorganization of Penn Central. He also described the discovery proceedings and trial preparation that could be anticipated if the action were to continue and the type of work interruption that activity could entail, which might well have an adverse effect on the Fund's shareholders. Mr. Souther pointed out that there could be a substantial cost to the Fund for attorneys' fees for its counsel as well as for outside directors who were found not liable to the Fund. Finally, he told them that they could properly consider not only the chances of securing a substantial judgment against Anchor Corporation and possibly the director defendants, but also the practical possibility of collecting such a judgment.

A. 120.

Mr. Souther's description of the costs and inconveniences of litigation was biased. As long as the Fund, through its own counsel, was seeking recovery for its Penn Central losses against Goldman, Sachs, any cost or disruption to Anchor was justified. But as soon as plaintiffs, through their own counsel, sought to recover the far greater balance of the losses from Anchor and the defendant directors, the costs and inconveniences became excessive and unjustified.

A. No. Because we were convinced that they had exercised what we felt was enough investigation into it.
Q. By relying on Goldman, Sachs?
A. And its willingness to repurchase.
Q. Did you believe—
A. And the Dun & Bradstreet rating.
Laun Tr. 75-76.

* Section 2(a)(19)(A)(iv), 15 U.S.C. §80a-2(a)(19)(A)(iv), defines "interested person" of an investment company as "any person or partner or employee of any person who at any time since the beginning of the last two fiscal years of such company has acted as legal counsel for such company."

At the quorum's January 6, 1975 meeting, Mr. Souther submitted a memorandum to the directors outlining the procedures for terminating Anchor's advisory contract and seeking a new adviser (A. 158). Rather than dispelling the directors' mistaken notion that they would have to terminate Anchor if this case went forward, Mr. Souther played out his part of the charade. Amidst a description of complexities, hardships and potentially harmful consequences of changing advisers, Mr. Souther's memorandum raised the spectre of a proxy contest, saying that "some shareholders" might oppose the selection of a new adviser and nominate their own slate of directors. The memorandum also indicated the prospect of a substantial number of shares being redeemed if there were a proxy contest and that such a contest might make it difficult for the Fund to obtain a new adviser (A. 159-60).

There is no question of the negative impact Mr. Souther's memorandum had on the minority directors. When asked of its effect, Ms. Robichaud testified

Q. What consideration did you attach to this document?

A. I attached to this document that it would fundamentally be in the bad interest of the stockholders to proceed with the suit. And that was the importance I attached to this document.

Q. Can you explain why?

A. Yes. As this document indicates, that if we were to proceed, let the suit proceed, there would be a question as to whether we would have to terminate the agreement with the investment advisor. And that, in seeing the sentence alone, would clearly not be in the interest of the stockholders.

Robichaud Tr. 107-08. Here, again, the minority directors were misled, rather than candidly informed. *See Papilsky* v. *Berndt,* [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,627, p. 90,133 (S.D.N.Y. 1976).

Even more amazing is Mr. Souther's lack of candor with respect to Judge Fuld. When Judge Fuld expressed inability to find specific authority dealing with the obligation of an investment adviser to conduct independent research, Mr. Souther apparently remained silent. He failed to disclose to Judge Fuld the legal authorities set forth above at pages 63-64. Particularly, he failed to disclose the crucial *Winfield* decision, even though he had been counsel in that litigation.

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It is obvious that the minority directors were not the beneficiaries of adequate information. The entire scheme devised to achieve dismissal of this action was carefully orchestrated. As part of that scheme, the "independent" directors and their special counsel were spoon-fed bits and pieces of information—some of it misleading—and were not informed as to other important facts. The true facts pertinent to consideration of what action was required in the interest of the stockholders of the Fund, as distinguished from the adviser, were not before the minority.

D. *The Continued Prosecution of This Action Cannot Possibly Injure the Fund*

Mr. Kendall's affidavit purports to list reasons why dismissal of this action was appropriate (A. 77-79). We have already dealt with most of these items and it is clear that the assertions are without merit. Only two need further mention: that business interruption to Anchor and its personnel would be harmful to the Fund and that the Fund would have to replace Anchor as its adviser.

The recent withdrawal by Anchor completely destroys these alleged grounds and removes any remaining vestige of reason why this case should not go forward on the merits.

Finally, Mr. Kendall attempts to belittle the size of the claim here in relation to the total assets of the Fund. With interest, the claim exceeds $20,000,000—clearly not a paltry sum. As stated in *Groel* v. *United Electric Co. of New Jersey*, 70 N.J.Eq. 616, 624, 61 A. 1061, 1064 (1905)

> It is perfectly clear that, if the complainant sets forth a good cause of action and there is a right in the corporation to recover $20,000,000 of stock from the promoter, it is a clear breach of trust on the part of the directors not to proceed to recover the same.
>
> For them to reply that it is by them deemed inexpedient to do so is only to emphasize the breach of trust they are committing by not doing so.

CONCLUSION

The order of the Court of Appeals should be affirmed in all respects and the case remanded for trial on its merits.

Respectfully submitted,

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APPENDIX

Investment Company Act

§1. *Findings and declaration of policy*

(a) Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 79z—4 of this title, and facts otherwise disclosed and ascertained, it is found that investment companies are affected with a national public interest in that, among other things—

(1) the securities issued by such companies, which constitute a substantial part of all securities publicly offered, are distributed, purchased, paid for, exchanged, transferred, redeemed, and repurchased by use of the mails and means and instrumentalities of interstate commerce, and in the case of the numerous companies which issue redeemable securities this process of distribution and redemption is continuous;

(2) the principal activities of such companies—investing, reinvesting, and trading in securities—are conducted by use of the mails and means and instrumentalities of interstate commerce, including the facilities of national securities exchanges, and constitute a substantial part of all transactions effected in the securities markets of the Nation;

(3) such companies customarily invest and trade in securities issued by, and may dominate and control or otherwise affect the policies and management of, companies engaged in business in interstate commerce;

(4) such companies are media for the investment in the national economy of a substantial part of the national savings and may have a vital effect upon the flow of such savings into the capital markets; and

(5) the activities of such companies, extending over many States, their use of the instrumentalities of interstate commerce and the wide geographic distribution of their security holders, make difficult, if not impossible, effective State regulation of such companies in the interest of investors.

(b) Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 79z—4 of this title, and facts otherwise disclosed and ascertained, it is declared that the national public interest and the interest of investors are adversely affected—

(1) when investors purchase, pay for, exchange, receive dividends upon, vote, refrain from voting, sell, or surrender securities issued by investment companies without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, policies, and financial responsibility of such companies and their management;

(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders;

(3) when investment companies issue securities containing inequitable or discriminatory provisions, or

fail to protect the preferences and privileges of the holders of their outstanding securities;

(4) when the control of investment companies is unduly concentrated through pyramiding or inequitable methods of control, or is inequitably distributed, or when investment companies are managed by irresponsible persons;

(5) when investment companies, in keeping their accounts, in maintaining reserves, and in computing their earnings and the asset value of their outstanding securities, employ unsound or misleading methods, or are not subjected to adequate independent scrutiny;

(6) when investment companies are reorganized, become inactive, or change the character of their business, or when the control or management thereof is transferred, without the consent of their security holders;

(7) when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities; or

(8) when investment companies operate without adequate assets or reserves.

It is declared that the policy and purposes of this subchapter, in accordance with which the provisions of this subchapter shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.

• • •

§2. ***Definitions***

(a) When used in this subchapter, unless the context otherwise requires—

. . .

(19) "Interested person" of another person means—

(A) when used with respect to an investment company—

(i) any affiliated person of such company,

(ii) any member of the immediate family of any natural person who is an affiliated person of such company,

(iii) any interested person of any investment adviser of or principal underwriter for such company,

(iv) any person or partner or employee of any person who at any time since the beginning of the last two fiscal years of such company has acted as legal counsel for such company,

(v) any broker or dealer registered under the Securities Exchange Act of 1934 or any affiliated person of such a broker or dealer, and

(vi) any natural person whom the Commission by order shall have determined to be an interested person by reason of having had, at any time since the beginning of the last two fiscal years of such company, a material business or professional relationship with such company or with the principal executive officer of such company or with any other investment company having the same

investment adviser or principal underwriter or with the principal executive officer of such other investment company:

Provided, That no person shall be deemed to be an interested person of an investment company solely by reason of (aa) his being a member of its board of directors or advisory board or an owner of its securities, or (bb) his membership in the immediate family of any person specified in clause (aa) of this proviso.

• • •

§10. ***Affiliations or interest of directors, officers, and employees***

(a) No registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are interested persons of such registered company.

(b) No registered investment company shall—

(1) employ as regular broker any director, officer, or employee of such registered company, or any person of which any such director, officer, or employee is an affiliated person, unless a majority of the board of directors of such registered company shall be persons who are not such brokers or affiliated persons of any of such brokers;

(2) use as a principal underwriter of securities issued by it any director, officer, or employee of such registered company or any person of which any such director, officer, or employee is an interested person, unless a majority of the board of directors of such registered company shall be persons who are not such

principal underwriters or interested persons of any of such principal underwriters; or

(3) have as director, officer, or employee any investment banker, or any affiliated person of an investment banker, unless a majority of the board of directors of such registered company shall be persons who are not investment bankers or affiliated persons of any investment banker. For the purposes of this paragraph, a person shall not be deemed an affiliated person of an investment banker solely by reason of the fact that he is an affiliated person of a company of the character described in section 80a—12(d)(3)(A)(B) of this title.

• • •

§13. *Changes in investment policy*

(a) No registered investment company shall, unless authorized by the vote of a majority of its outstanding voting securities—

. . .

(3) deviate from its policy in respect of concentration of investments in any particular industry or group of industries as recited in its registration statement, deviate from any investment policy which is changeable only if authorized by shareholder vote, or deviate from any policy recited in its registration statement pursuant to section 80a—8(b)(3) of this title:

• • •

§15. *Contracts of advisers and underwriters*

. . .

(c) In addition to the requirements of subsections (a) and (b) of this section, it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party, cast in person at a meeting called for the purpose of voting on such approval. It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company. It shall be unlawful for the directors of a registered investment company, in connection with their evaluation of the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company, to take into account the purchase price or other consideration any person may have paid in connection with a transaction of the type referred to in paragraph (1), (3), or (4) of subsection (f) of this section.

• • •

§16. *Board of directors; election; term vacancies; trustees of common-law trusts*

. . .

(b) Any vacancy on the board of directors of a registered investment company which occurs in connection with compliance with section 80a—15(f)(1)(A) of this title and which must be filled by a person who is not an interested

person of either party to a transaction subject to section 80a—15(f)(1)(A) of this title shall be filled only by a person (1) who has been selected and proposed for election by a majority of the directors of such company who are not such interested persons, and (2) who has been elected by the holders of the outstanding voting securities of such company, except that in the case of the death, disqualification, or bona fide resignation of a director selected and elected pursuant to clauses (1) and (2) of this subsection (b), the vacancy created thereby may be filled as provided in subsection (a) of this section.

* * *

§17. *Transactions of certain affiliated persons and underwriters*

(a) It shall be unlawful for any affiliated person or promoter of or principal underwriter for a registered investment company (other than a company of the character described in section 80a—12(d) (3) (A) and (B) of this title), or any affiliated person of such a person, promoter, or principal underwriter, acting as principal—

(1) knowingly to sell any security or other property to such registered company or to any company controlled by such registered company, unless such sale involves solely (A) securities of which the buyer is the issuer, (B) securities of which the seller is the issuer and which are part of a general offering to the holders of a class of its securities, or (C) securities deposited with the trustee of a unit investment trust or periodic payment plan by the depositor thereof;

(2) knowingly to purchase from such registered company, or from any company controlled by such registered company, any security or other property (except securities of which the seller is the issuer); or

(3) to borrow money or other property from such registered company or from any company controlled by such registered company (unless the borrower is controlled by the lender) except as permitted in section 80a—21(b) of this title.

(b) Notwithstanding subsection (a) of this section, any person may file with the Commission an application for an order exempting a proposed transaction of the applicant from one or more provisions of said subsection. The Commission shall grant such application and issue such order of exemption if evidence establishes that—

(1) the terms of the proposed transaction, including the consideration to be paid or received, are reasonable and fair and do not involve overreaching on the part of any person concerned;

(2) the proposed transaction is consistent with the policy of each registered investment company concerned, as recited in its registration statement and reports filed under this subchapter; and

(3) the proposed transaction is consistent with the general purposes of this subchapter.

(c) Notwithstanding subsection (a) of this section, a person may, in the ordinary course of business, sell to or purchase from any company merchandise or may enter into a lessor-lessee relationship with any person and furnish the services incident thereto.

(d) It shall be unlawful for any affiliated person of or principal underwriter for a registered investment company

(other than a company of the character described in section 80a—12(d) (3) (A) and (B) of this title), or any affiliated person of such a person or principal underwriter, acting as principal to effect any transaction in which such registered company, or a company controlled by such registered company, is a joint or a joint and several participant with such person, principal underwriter, or affiliated person, in contravention of such rules and regulations as the Commission may prescribe for the purpose of limiting or preventing participation by such registered or controlled company on a basis different from or less advantageous than that of such other participant. Nothing contained in this subsection shall be deemed to preclude any affiliated person from acting as manager of any underwriting syndicate or other group in which such registered or controlled company is a participant and receiving compensation therefor.

(e) It shall be unlawful for any affiliated person of a registered investment company, or any affiliated person of such person—

(1) acting as agent, to accept from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property to or for such registered company or any controlled company thereof, except in the course of such person's business as an underwriter or broker; or

(2) acting as broker, in connection with the sale of securities to or by such registered company or any controlled company thereof, to receive from any source a commission, fee, or other remuneration for effecting such transaction which exceeds (A) the usual and customary broker's commission if the sale is effected on a securities exchange, or (B) 2 per centum of the sales price if the sale is effected in connection with a secondary distribution of such securities, or (C) 1 per centum of the purchase or sale price of such securities if the sale is otherwise effected unless the Commission shall, by rules and regulations or order in the public interest and consistent with the protection of investors, permit a larger commission.

(f) Every registered management company shall place and maintain its securities and similar investments in the custody of (1) a bank or banks having the qualifications prescribed in paragraph (1) of section 80a—26(a) of this title for the trustees of unit investment trusts; or (2) a company which is a member of a national securities exchange as defined in the Securities Exchange Act of 1934, subject to such rules and regulations as the Commission may from time to time prescribe for the protection of investors; or (3) such registered company, but only in accordance with such rules and regulations or orders as the Commission may from time to time prescribe for the protection of investors. Subject to such rules, regulations, and orders as the Commission may adopt as necessary or appropriate for the protection of investors, a registered management company or any such custodian, with the consent of the registered management company for which it acts as custodian, may deposit all or any part of the securities owned by such registered management company in a system for the central handling of securities established by a national securities exchange or national securities association registered with the Commission under the Securities Exchange Act of 1934, or such other person as may be per-

mitted by the Commission, pursuant to which system all securities of any particular class or series of any issuer deposited within the system are treated as fungible and may be transferred or pledged by bookkeeping entry without physical delivery of such securities. Rules, regulations, and orders of the Commission under this subsection, among other things, may make appropriate provision with respect to such matters as the earmarking, segregation, and hypothecation of such securities and investments, and may provide for or require periodic or other inspections by any or all of the following: Independent public accountants, employees and agents of the Commission, and such other persons as the Commission may designate. No such member which trades in securities for its own account may act as custodian except in accordance with rules and regulations prescribed by the Commission for the protection of investors. If a registered company maintains its securities and similar investments in the custody of a qualified bank or banks, the cash proceeds from the sale of such securities and similar investments and other cash assets of the company shall likewise be kept in the custody of such a bank or banks, or in accordance with such rules and regulations or orders as the Commission may from time to time prescribe for the protection of investors, except that such a registered company may maintain a checking account in a bank or banks having the qualifications prescribed in paragraph (1) of section 80a—26(a) of this title for the trustees of unit investment trusts with the balance of such account or the aggregate balances of such accounts at no time in excess of the amount of the fidelity bond, maintained pursuant to subsection (g) of this section, covering the officers or employees authorized to draw on such account or accounts.

(g) The Commission is authorized to require by rules and regulations or orders for the protection of investors that any officer or employee of a registered management investment company who may singly, or jointly with others, have access to securities or funds of any registered company, either directly or through authority to draw upon such funds or to direct generally the disposition of such securities (unless the officer or employee has such access solely through his position as an officer or employee of a bank) be bonded by a reputable fidelity insurance company against larceny and embezzlement in such reasonable minimum amounts as the Commission may prescribe.

(h) After one year from the effective date of this subchapter, neither the charter, certificate of incorporation, articles of association, indenture of trust, nor the by-laws of any registered investment company, nor any other instrument pursuant to which such a company is organized or administered, shall contain any provision which protects or purports to protect any director or officer of such company against any liability to the company or to its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his office.

In the event that any such instrument does not at the effective date of this chapter comply with the requirements of this subsection and is not amended to comply therewith prior to the expiration of said one year, such company may nevertheless continue to be a registered investment company and shall not be deemed to violate this subsection if prior to said expiration date each such director or officer shall have filed with the Commission a waiver in writing of any protective provision of the in-

strument to the extent that it does not comply with this subsection, and each such person subsequently elected or appointed shall before assuming office file a similar waiver.

(i) After one year from the effective date of this subchapter no contract or agreement under which any person undertakes to act as investment adviser of, or principal underwriter for, a registered investment company shall contain any provision which protects or purports to protect such person against any liability to such company or its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith, or gross negligence, in the performance of his duties, or by reason of his reckless disregard of his obligations and duties under such contract or agreement.

In the event that any such contract or agreement does not at the effective date of this chapter comply with the requirements of this subsection and is not amended to comply therewith prior to the expiration of said one year, this subsection shall not be deemed to have been violated if prior to said expiration date each such investment adviser or principal underwriter shall have filed with the Commission a waiver in writing of any protective provision of the contract or agreement to the extent that it does not comply with this subsection.

(j) It shall be unlawful for any affiliated person of or principal underwriter for a registered investment company or any affiliated person of an investment adviser of or principal underwriter for a registered investment company, to engage in any act, practice, or course of business in connection with the purchase or sale, directly or indirectly, by such person of any security held or to be acquired by such registered investment company in contravention of such

rules and regulations as the Commission may adopt to define, and prescribe means reasonably necessary to prevent, such acts, practices, or courses of business as are fraudulent, deceptive or manipulative. Such rules and regulations may include requirements for the adoption of codes of ethics by registered investment companies and investment advisers of, and principal underwriters for, such investment companies establishing such standards as are reasonably necessary to prevent such acts, practices, or courses of business.

* * *

§32. *Accountants and auditors*

(a) It shall be unlawful for any registered management company or registered face-amount certificate company to file with the Commission any financial statement signed or certified by an independent public accountant, unless—

(1) such accountant shall have been selected at a meeting held within thirty days before or after the beginning of the fiscal year or before the annual meeting of stockholders in that year by the vote, cast in person, of a majority of those members of the board of directors who are not interested persons of such registered company;

(2) such selection shall have been submitted for ratification or rejection at the next succeeding annual meeting of stockholders if such meeting be held, except that any vacancy occurring between annual meetings, due to the death or resignation of the accountant, may be filled by the vote of a majority of those members of the board of directors who are not interested persons

of such registered company, cast in person at a meeting called for the purpose of voting on such action;

(3) the employment of such accountant shall have been conditioned upon the right of the company by vote of a majority of the outstanding voting securities at any meeting called for the purpose to terminate such employment forthwith without any penalty; and

(4) such certificate or report of such accountant shall be addressed both to the board of directors of such registered company and to the security holders thereof.

If the selection of an accountant has been rejected pursuant to paragraph (2) or his employment terminated pursuant to paragraph (3), the vacancy so occurring may be filled by a vote of a majority of the outstanding voting securities, either at the meeting at which the rejection or termination occurred or, if not so filled, at a subsequent meeting which shall be called for the purpose. In the case of a common-law trust of the character described in section 80a—16(c) of this title, no ratification of the employment of such accountant shall be required but such employment may be terminated and such accountant removed by action of the holders of record of a majority of the outstanding shares of beneficial interest in such trust in the same manner as is provided in section 80a—16(c) of this title in respect of the removal of a trustee, and all the provisions therein contained as to the calling of a meeting shall be applicable. In the event of such termination and removal, the vacancy so occurring may be filled by action of the holders of record of a majority of the shares of beneficial interest either at the meeting, if any, at which such termination and removal occurs, or by instruments in writing filed with the custodian,

or if not so filed within a reasonable time then at a subsequent meeting which shall be called by the trustees for the purpose. The provisions of paragraph (42) of section 80a—2(a) of this title as to a majority shall be applicable to the vote cast at any meeting of the shareholders of such a trust held pursuant to this subsection.

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§36. [Effective prior to December 14, 1970]
Injunctions against Gross Abuse

The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has been guilty, after August 22, 1940, and within five years of the commencement of the action of gross misconduct or gross abuse of trust in respect of any registered investment company for which such person so serves or acts—

(1) as officer, director, member of any advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If the Commission's allegations of such gross misconduct or gross abuse of trust are established, the court shall enjoin such person from acting in such capacity or capacities either permanently or for such period of time as it in its discretion shall deem appropriate.

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§36. [Effective December 14, 1970]

Breach of fiduciary duty—Civil actions by Commission; jurisdiction; allegations; injunctive or other relief

(a) The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts—

(1) as officer, director, member of any advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of the policies declared in section 80a—1(b) of this title.

Compensation or payments as basis of fiduciary duty; civil actions by Commission or security holder; burden of proof; judicial consideration of director or shareholder approval; persons liable; extent of liability; exempted transactions; jurisdiction; finding restriction

(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of con-

tracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a—17 of this title, or rules, regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this subchapter for the purposes of sections 80a—9 and 80a—48 of this title, section 78 of this title, or section 80b—3 of this title, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

Investment Advisers Act

§206. ***Prohibited transactions by investment advisers***

It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

(3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction;

(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

Federal Rules of Civil Procedure

Rule 23.1. *Derivative Actions by Shareholders*

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.